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February 27, 2004

VIA E-MAIL and FEDERAL EXPRESS

The Honorable James T. Odiorne
Deputy Insurance Commissioner
Company Supervision
Washington Office of the Insurance Commissioner
5000 Capitol Boulevard
Tumwater, Washington 98501

Re: PREMERA; Our File No. 61000-002

Dear Mr. Odiorne:

CANTILO & BENNETT, L.L.P. ("C&B") has been engaged by the Office of the Insurance Commissioner of the State of Washington (the "OIC") to assist in the evaluation of a proposal by the Premera Group ("PREMERA") to convert from nonprofit to for-profit, in part by changing the ultimate controlling entity of PREMERA's members, which are regulated by the Insurance Commissioner of the State of Washington (the "Commissioner") pursuant to WASH. REV. CODE ANN §§ 48.01.0100–.120.025 (West, WESTLAW through Chapter 1 of 2004 Regular Session) ("Washington Insurance Code"). In fulfilling the initial engagement (the "Original Engagement"), C&B transmitted to the OIC on October 27, 2003, a letter and final report ("C&B's Final Report" or the "Final Report") of the analysis conducted by C&B of PREMERA's Form A submitted on September 17, 2002, as amended on October 25, 2002 (the "Original Form A"). On December 11, 2002, and on January 9, 2003, the Commissioner entered orders that permitted PREMERA to discuss with the OIC and the consultants the concerns of the OIC's consultants, which had been raised in their reports issued on October 27, 2003. Moreover, the orders permitted the Intervenors, as defined by the Commissioner, to observe any discussions between the OIC, its consultants, and PREMERA. PREMERA would then be required to amend its Original Form A, if at all, by February 5, 2004 (the "Amended Form A"). The OIC engaged C&B to submit this letter and a supplemental report (the "Supplemental Report" or "C&B's Supplemental Report") analyzing the effect of the changes, if any, manifested in the Amended Form A (the "Supplemental Engagement").

This letter explains the context of this analysis and summarizes C&B's views based on (1) the Amended Form A as currently constituted, (2) the information made available thus far, (3) C&B's Final Report, and (4) the final and supplemental reports submitted by the OIC's other consultants. Thus, this letter should serve as an executive summary (the "Executive Summary") of

C&B's Supplemental Report ("the Supplemental Report" together with C&B's earlier reports are referred to collectively as "C&B's Analysis"). PREMERA's currently proposed conversion shall be referred to as the "Transaction" or the "Amended Transaction," and PREMERA's proposed transaction as of the date of C&B's Final Report shall be referred to as the "Original Transaction." C&B's Supplemental Report explains the facts and information reviewed by C&B, the context of the analysis, and important assumptions and qualifications regarding C&B's conclusions. This Executive Summary must be read together with C&B's Supplemental Report and Final Report, as well as the reports of the OIC's other consultants, and the OIC should not rely solely upon this Executive Summary.

ISSUES CONSIDERED

The Supplemental Report will at times reference or summarize discussions in the Final Report. For ease of reference, this Supplemental Report's format will mirror that of the Final Report, to the extent possible. Due to the nature of the Original Engagement, the Final Report was analyzed in two separate and distinct stages (herein referred to as "Stage One" and "Stage Two"). In C&B's Final Report, however, the two stages had largely been combined because analysis of the Original Transaction had not progressed in the manner contemplated originally by the OIC. C&B, thus, had analyzed many of the Stage Two matters together with those originally envisioned as constituting Stage One. With respect to the Supplemental Report, C&B has combined discussion of the Stage One and Stage Two assignments to the extent required to describe the analysis in a manner comparable to that embodied in the Final Report. C&B has provided an analysis and opinion as to the following Stage One issues: (1) whether PREMERA has complied with the appropriate change of control filing requirements, (2) whether the Amended Transaction is economically viable, (3) whether PREMERA has complied with applicable law, including the Washington Insurance Code, applicable Washington Administrative Code ("WASH. ADMIN. CODE") provisions, WASH. REV. CODE ANN. §§ 24.03.005–.46.020 ("Washington Nonprofit Corporation Act"), and certain provisions of federal law, and (4) whether the Amended Transaction is fair to policyholders,[1] health care providers, and the public. The Amended Transaction's Stage Two issues analyzed in the Supplemental Report that are comparable to those analyzed within the Final Report are as follows: (1) conversion-related self-dealing and conflicts of interest of PREMERA's officers and trustees, (2) the independence of the Washington Foundation[2] on the one hand, and PREMERA on the other hand, and (3) the stock transfer documents and the related transfer of PREMERA's fair

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[1] The terms "policyholder" and "subscriber" may be used interchangeably or together throughout C&B's Analysis.

[2] With respect to the second assignment of Stage Two, the Final Report refers to the Foundation Shareholder and Charitable Organizations rather than the Washington Foundation because PREMERA had not at that time replaced the Foundation Shareholder and Charitable Organizations with the Washington Foundation and the Alaska Foundation (referred to collectively as the "Foundations"). In addition, for reasons that are not apparent, PREMERA refers to the Washington Foundation as the "Washington Foundation Shareholder." The structure of the Amended Transaction does not bifurcate the foundation functions between a shareholder and a Charitable Organization, as had the Original Transaction. C&B will therefore refer to this entity as the Washington Foundation, not the Washington Foundation Shareholder. The terms Foundation Shareholder, Charitable Organizations, Washington Foundation, and Alaska Foundation are defined in the Supplemental Report.

market value. As seen in the Final Report, many of the matters identified originally as pertaining to Stage One and those pertaining to Stage Two overlapped and were substantially interrelated, which accounted for the decision to combine them in one Final Report. Although the Supplemental Engagement did not involve the separation of issues between Stage One and Stage Two, C&B has generally kept intact the Final Report's format for this Supplemental Report.

As part of the Final Report, C&B reviewed information and materials that were available as of October 15, 2003, pursuant to the Commissioner's Sixteenth Order. On October 17, 2003, PREMERA made what essentially amounted to a material amendment of the Original Form A by submitting a stock ownership plan ("SOP") that it proposed to adopt upon approval of the Original Transaction. As will be seen, the SOP arguably is germane to two issues addressed in C&B's Final Report: (1) whether the Amended Transaction is fair to policyholders, health care providers, and the public, and (2) whether there exist conversion-related self-dealing and conflicts of interest of PREMERA's officers and trustees. The OIC had, thus, requested C&B to analyze the SOP to determine its fairness, and to determine whether the Transaction gives rise to certain conflicts of interest or self-dealing. On November 26, 2003, C&B submitted to the OIC a report containing its analysis of PREMERA's stock ownership and executive compensation plans (the "Executive Compensation Report"). The issues analyzed within the Executive Compensation Report have been incorporated into the Supplemental Report.

OTHER ISSUES

In addition to the Stage One and Stage Two issues, and the issues identified in the Executive Compensation Report, the OIC requested that C&B submit analyses that were not contemplated within the scope of the foregoing issues. On January 16, 2004, and on February 19, 2004, C&B provided the OIC, at its requests, confidential opinions and analyses regarding the following, respectively: (1) the merits of certain arguments made by the Oregon Attorney General's office as to whether the State of Oregon was entitled to a portion of PREMERA's assets (the "Oregon Analysis"), and (2) certain legal issues concerning the allocation of consideration in the event that the Original Transaction[3] were to be implemented (the "Allocation Analysis").[4] Neither the Oregon Analysis nor the Allocation Analysis were contemplated in C&B's Supplemental Engagement with respect to the issues to be analyzed in the Supplemental Report, and are not addressed in C&B's Analysis provided herewith.

LIMITATIONS AND QUALIFICATIONS

C&B's Analysis is issued exclusively to the OIC, and only the OIC may rely upon it. C&B's Analysis may not be quoted, in whole or in part, without C&B's written consent. Except to the

[3] The Amended Transaction had not been filed at the time the Oregon Analysis was provided, but C&B's analysis is not expected to change as a result of the amendment. The changes in the Amended Transaction do not affect the fundamental elements of the Oregon analysis.

[4] A preliminary draft of the Allocation Analysis was submitted to the OIC on August 25, 2003.

extent expressly agreed upon as part of the Engagement, C&B will have no obligation to "bring down" or update C&B's Analysis after it is first issued.

In conducting its analysis, C&B has relied on the sufficiency and accuracy of the information provided by PREMERA, the OIC, the OIC's other consultants or advisors, and other sources. C&B's Analysis evaluates the Transaction based on information gathered and analyzed through February 5, 2004. A description of the information provided by PREMERA after October 15, 2003, which has been reviewed by C&B and the other consultants, is provided in Appendix I. In addition, C&B and the other consultants have attended numerous meetings, and participated in numerous telephone calls, with PREMERA's management, key employees, counsel, and its advisors, as well as with state officials and their advisors. Moreover, as part of its analysis, C&B has reviewed the reports provided by the other consultants and has incorporated selected excerpts in this Supplemental Report. C&B's Analysis should be read in conjunction with the reports of the other consultants. Additionally, C&B makes reference in its analysis to C&B's Final Report whenever a particular issue is discussed more fully in the Final Report. C&B's Analysis, thus, should be read together with the Final Report. For the sake of simplicity and economy, and due to the expedited schedule, citations to some specific PREMERA documents that were submitted, amended, or updated, after the issuance of C&B's Final Report have been omitted.

C&B has made diligent efforts to request, and to assist other OIC advisors in requesting and obtaining, from PREMERA, all of the information necessary for an adequate review of the relevant issues raised by the Amended Transaction. Although PREMERA appears to have made substantial efforts to provide the information requested, a number of potentially important documents have not been provided due to PREMERA's claims of attorney-client privilege or the doctrine of work-product. Judge George Finkle, the Special Master appointed by the Commissioner, conducted *in camera* reviews of these documents and issued opinions, which sustained a majority of PREMERA's claims. The applicability of C&B's Analysis is limited to the extent that the materials withheld, if produced, would have altered C&B's conclusions.

Many of the issues considered in C&B's Analysis relate to prospective events, anticipated conduct, and possible consequences following the Amended Transaction's proposed implementation. C&B has made assumptions regarding these matters, that it believes are reasonable, in light of the information provided by PREMERA and other sources. Where relevant, these assumptions are identified in this report. If future conduct and events differ materially from those which are assumed in C&B's Analysis, the observations and recommendations provided herein may be less applicable, or inapplicable altogether. Generally, C&B's Analysis is based on the Amended Transaction's structure as of February 5, 2004.

To the best of C&B's knowledge, no direct legal precedent exists in Washington for the analysis of many of the pertinent issues. Due to the paucity of specific case law in this and other jurisdictions, as well as the unique nature of the issues to be opined upon, a substantial portion of C&B's Analysis is based on analogous statutes and case law from this and other jurisdictions, as well as C&B's general experience in these areas. To the best of C&B's knowledge and experience, C&B's Analysis provides a reasonable evaluation of the relevant issues. C&B's Analysis is based on the law as it existed at the time of the analysis. There can be no assurance that any of the relevant law will not change prior to the Amended Transaction's implementation, and C&B's Analysis may be less applicable, or inapplicable, to the extent of such changes.

SUMMARY OF C&B'S CONCLUSIONS

Throughout the review of the Original Transaction by Washington and Alaska regulators, and by their consultants, PREMERA officials were advised of aspects of the proposed conversion about which the reviewers were concerned in the context of applicable standards. But the Original Form A and related documents were not then amended to address these matters. Around the time, in October 2003, at which the reports of the OIC's consultants were finalized and made public, PREMERA representatives commenced a series of discussions to address many of the observations and criticisms of the conversion expressed in those reports. With the clear understanding that structuring of the Transaction was exclusively PREMERA's responsibility, public officials and their consultants participated in numerous meetings and teleconferences with the company and its advisors. In these discussions, the specifics of the concerns raised by the Original Transaction, and ways of addressing many of them, were explored in depth. Following this informative process, PREMERA again amended its proposed Original Form A by filing, on February 5, 2004, a set of revised documents.

To be sure, the Amended Transaction reflects efforts by PREMERA to respond to many of the issues and criticisms raised in the October reports and in the ensuing discussions. As more fully detailed in the accompanying report, the result has been the elimination or alteration of certain aspects of the Original Transaction that were deemed by the OIC's advisors to create substantial doubt as to the ability of the conversion to satisfy applicable legal requirements. But there remain a significant number of issues brought to PREMERA's attention, for which no remedial steps are reflected in the Amended Transaction. While it may be difficult to quantify the potential adverse impact of some of these issues in isolation, it is evident that, in the aggregate, they present substantial and troubling questions as to the extent to which the proposed conversion can be deemed to be consistent with the interest of the insurance buying public and to satisfy other applicable statutory conditions for approval. Mindful as ever that Washington law imposes upon the Commissioner and the OIC the burden of demonstrating that the Transaction fails statutory requirements, this report discusses these concerns singly and in combination, seeking thereby to inform the Commissioner about their anticipated effect on the constituencies sought to be protected by the applicable laws.

In general, the impact of the Transaction, for purposes of this discussion, can be understood to arise principally in two contexts: (1) the effect of the conversion on health care coverages, and (2) conveyance of the requisite value to the citizens of the State of Washington. Regrettably, issues left unresolved at this juncture raise substantial concerns in both contexts. In short, while the Amended Transaction represents a notable improvement over the Original Transaction, it does not, in the judgment of these reviewers, dispose effectively of all the material concerns brought to PREMERA's attention. The following paragraphs will examine the conclusions first reached by C&B in its October report, and evaluate them in the context of the Amended Transaction. They will also discuss additional issues that have arisen as a result of the changes made by PREMERA.

Each of the Stage One and Stage Two issues considered in C&B's Final Report is described below with conclusions from that report, along with any changes to those conclusions as a result of the analysis in the Supplemental Report. For each conclusion originally expressing concern or reservations about the Original Transaction, the Supplemental Report examines the extent to which the Amended Transaction eliminates the concern or reservation. The Supplemental Report also considers the cumulative effect of the remaining issues on the degree to which the Amended Transaction complies with applicable legal requirements. Undefined terms in the following section are defined in the Supplemental Report.

STAGE ONE

1. Has PREMERA complied with the appropriate change of control filing requirements?

   a. **Final Report Conclusion #1.** PREMERA's Original Form A cannot be deemed complete until the items listed in the deficiency schedule sent to PREMERA on September 10, 2003, are satisfied, including: (a) Description of SOP (Exhibit G-10), and (b) Schedules 1 (Assets) and 2 (Assumed Liabilities) to Exhibit D (Exhibit G-11 to the Form A). Executive compensation plans provided after the October 15, 2003, amendment deadline cannot cure that deficiency, in part, because there has not been a reasonable opportunity for sufficient review of these plans.

   b. **Supplemental Report Conclusion #1.** PREMERA has provided the items listed on the deficiency schedule sent to PREMERA on September 10, 2003. A reasonable opportunity has been provided to review the executive compensation plans provided after October 15, 2003. The Amended Transaction has cured the issue presented in this Final Report Conclusion ("FRC").

   c. **Final Report Conclusion #2.** An issue that arises under applicable law, is whether the Foundation Shareholder will have "control" of New PREMERA, by virtue of the stock proposed to be conveyed as part of the Original Transaction. "Control" is a term specifically defined in the applicable statute, and the existence of control has substantial consequences. PREMERA suggests, inappropriately, that a Disclaimer of Control filing serves to eliminate control. Whether or not control exists (or would exist if the Original Transaction were implemented) depends on the elements of the Original Transaction. The disclaimer can do no more than describe those elements. It cannot eliminate control created by the Original Transaction. Thus, an appropriate explanation for the suggested absence of control would cite to the Stock Governance Agreements and other organizational documents intended to eliminate the Foundation Shareholder's control of New PREMERA. Notably, by virtue of those same and related provisions, those agreements may undermine the transfer of PREMERA's fair market value to the Foundation Shareholder and Charitable Organizations. Though PREMERA does not explicitly concede this point, analysis of the conversion by the OIC and its advisors has been premised on the principle that conveyance of PREMERA's full market value is a fundamental legal requirement for satisfaction of the public's stake in the company.[5] It is evident, in any event, that PREMERA has designed the Original Transaction so that the Foundation Shareholder and Charitable Organizations cannot exercise the authority and control typically inherent in the level of ownership proposed for these entities. Therefore, whether or not the Stock Governance Agreements fail a fundamental legal requirement, for purposes of the public policies underlying the WASH. REV. CODE ANN. §§ 48.31B.005–.902 (the Insurer Holding Company Act ("IHCA")) and WASH. REV. CODE ANN. §§ 48.31C.010–.910 (the Holding Company Act for Health Care Service Contractors and Health Maintenance Organizations ("HHCA")) (collectively referred to as "Holding Company Acts") and other applicable law, New PREMERA should be treated as the acquiring person. And this is so even if the purported disclaimer and the restrictions do not compel that result.

d. **Supplemental Report Conclusion #2.** The Amended Transaction does not substantively alter this FRC.

2. Is the Amended Transaction economically viable?

a. **Final Report Conclusion #3.** While economic viability is a broad term that might encompass a variety of analyses, in the context of the Original Transaction, it refers primarily to the consideration proposed to be paid by the buyer (New PREMERA and its future investors) to the seller (the citizens of the State of Washington) for the sale of PREMERA. In broader terms, economic viability turns on whether the public's interest in PREMERA is safeguarded in the Original Transaction. In effect, that requires a determination as to whether the fair market value of PREMERA will be conveyed to the Foundation Shareholder and the Charitable Organizations, and will thereafter inure exclusively to the benefit of the public. Initially, economic viability involves the extent to which PREMERA will be able to complete a successful initial public offering ("IPO"), which depends on several factors, including whether the company follows proper procedures in the IPO. However, there are several potential negative factors that may affect the economic viability of the IPO, as defined in The Blackstone Group L.P.'s ("Blackstone") letter opinion. Moreover, even a successful IPO, properly conducted, would not guarantee that the Original Transaction will be economically viable in the sense described here. A variety of stock restrictions and other conditions proposed by PREMERA to be imposed on the Foundation Shareholder and Charitable Organizations are likely to reduce materially the value of the consideration received by them. That reduction

[5] In what it may view as effective avoidance of this issue, PREMERA concedes merely that it has agreed to convey "100% of its stock to the Foundation Shareholder, which represents the fair market value of the company upon consummation of the conversion transaction." PREMERA may argue that this is not a required element of the Amended Transaction, but it clearly offers it as an inducement to its approval. Whether or not PREMERA agrees that it must convey its fair market value, it claims that the conversion would do so. Observations by C&B and other OIC consultants to the effect that elements of the Amended Transaction fail to achieve this result are, therefore, clearly material to the Commissioner's determination.

may result in the aggregate consideration falling so far short of PREMERA's fair market value that the applicable legal requirement (or, by PREMERA's reckoning, an important element of its proposal) will not have been met.

b. **Supplemental Report Conclusion #3.** Some of the concerns in FRC #3 are mitigated to some degree by the proposed issuance of an IPO Procedures Opinion, for the preparation of which financial advisers, acting on the Commissioner's behalf, will be given access to the information and pricing of the Shares in the IPO. These advisers eventually will issue an opinion encompassing, *inter alia*, the economic viability of the Transaction. There are two material problems, however, with PREMERA's proposal regarding the opinion. First, in order for the IPO Procedures Opinion to be reliable, Blackstone believes PREMERA should make a preliminary proposal regarding the parameters of the contemplated IPO to the OIC and its advisors with sufficient time for review (*i.e.*, four weeks prior to the "road show"). Second, the Washington Foundation should have the right to access, and rely, on the information on which the IPO Procedures Opinion will be based. Otherwise, the Washington Foundation should be permitted to appoint a joint book running manager in order to protect its interests. Furthermore, it is necessary for the IPO to occur within a reasonable time following the Commissioner's approval in order to avoid a scenario in which material changes have occurred in the matters upon which the Commissioner relied in his decision. If PREMERA did not intend section 4.3(b) of the Plan of Conversion to include the IPO, then the Transaction does not satisfy this concern. It may be impractical to require that the IPO close very shortly after the Commissioner's order, because PREMERA will need to develop and market a successful IPO, and to satisfy all federal regulatory rules in conducting an IPO, after the Commissioner's decision has become final. Were this not the case, there would remain at the time of the IPO a significant contingency, namely the viability of the Commissioner's approval. However, the longer the lapse of time between the receipt of all regulatory approvals, and the IPO, the greater the likelihood of intervening material changes. PREMERA has provided itself 12 months after the receipt of all regulatory approvals (the "Initial Time Period") and two three-month automatic extensions if there is pending litigation. Although the Initial Time Period may not be unreasonable given the contemplated "bring down" procedure, the proposed automatic extensions infringe upon the Commissioner's authority to determine whether additional time is warranted for conducting the IPO. Lastly, the Initial Time Period does not begin until all regulatory approvals have been received, and until approval from the BCBSA is received with respect to the License Agreement. It is inappropriate to condition the Transaction on the BCBSA's approval because it is not a regulatory authority and not a party to this proceeding. The flexibility required for PREMERA to conduct a successful IPO, moreover, should be balanced against the possibility that material changes will occur affecting the Amended Form A during the Initial Time Period. The Bring Down Opinions will provide some safeguard against a material change, to the extent that the underlying information provided by PREMERA (the "Reportable Changes") is adequate for the Consultants' review.

These Reportable Changes, however, fail to provide sufficient information on several areas material to the Commissioner's review of the Transaction.

3. Has PREMERA complied with applicable law, including the Washington Insurance Code, applicable WASH. ADMIN. CODE provisions, Washington Nonprofit Corporation Act, and certain federal law?

   a. **Final Report Conclusion #4.** C&B has been advised by the OIC that there do not appear to be any material issues regarding the transfer of the health care and insurance licenses and registrations of the nonprofit companies. Those transfers, therefore, are likely to be approved by the OIC if the Original Transaction complies with other applicable requirements.

   b. **Supplemental Report Conclusion #4.** The Amended Transaction does not alter this FRC.

   c. **Final Report Conclusion #5.** Although PREMERA appears to have market power in eastern Washington, it is improbable that the Original Transaction would violate antitrust laws because it does not appear that it will result in an immediate increase in market share. It is possible that access to additional capital will enable PREMERA to engage in anti-competitive behavior that would not have been possible without such capital. Nothing brought to C&B's attention indicates an intent by PREMERA to engage in such behavior. It is possible that the need to satisfy investor expectations may induce PREMERA to increase premium rates, or reduce provider compensation, either or both of which may have an adverse effect on the markets in which PREMERA operates. This issue is discussed in some depth in the Final Report and in the work of PricewaterhouseCoopers LLP ("PwC").

   d. **Supplemental Report Conclusion #5.** The Amended Transaction does not alter FRC #5 which states that it is improbable that the Amended Transaction will violate antitrust laws. The Amended Transaction does alter the conclusion, to some degree, that investor expectations may cause an increase in premium rates. PREMERA has provided certain assurances that limit the methods by which PREMERA sets premium rates. These assurances, however, are only for a two-year period following the effective date of the conversion, which may not be a sufficient length of time. PwC proposes a period of not less than three years. Regardless of the length of the time period, PREMERA may be able to manipulate premium rates at the expiration of its assurances.

   e. **Final Report Conclusion #6.** PREMERA's Form D appears to satisfy the applicable informational requirements. PwC's analysis indicates that PREMERA has satisfied the Form D's substantive requirements with respect to the Cost Agreement and Management Agreement, because those agreements, as well as charges proposed for services to be performed, appear to be fair and reasonable, and the expenses incurred and payments received apparently will be allocated according to customary statutory accounting practices consistently applied. The Tax Agreement, however, does not satisfy the foregoing legal standards because one of the provisions may result in members not being reimbursed for certain tax attributes generated on a separate return basis.

f. **Supplemental Report Conclusion #6.** The Amended Transaction does not alter the conclusion that the Form D satisfies the applicable informational requirements, and that the substantive requirements with respect to the Management Agreement and Cost Agreement are fair and reasonable. The Amended Transaction does amend the Tax Agreement in such a way which also makes that agreement fair and reasonable. The Guaranty Agreements provide for different levels of claims guarantee depending on whether New PREMERA makes the guarantee to New PBC or PBC-AK. The Commissioner should require that the claims guarantees mirror each other.

g. **Final Report Conclusion #7.** The transfer of insurance contracts between PBC and New PBC, and LifeWise of Washington, and New LifeWise of Washington, should not be approved as contemplated in the Original Transaction in the absence of express adequate assurances that the transfer will not result in adverse changes in the terms or cost of coverage. While the Original Transaction's documents contain no such assurance, it is likely that PREMERA would provide such assurances, and it would not be inappropriate to condition an approval order on such a requirement.

h. **Supplemental Report Conclusion #7.** Although the Amended Transaction does provide for an assurance that the terms of insurance coverage will not change, it does not provide such assurance with respect to the cost of coverage. With respect to the cost of coverage, PREMERA has provided some assurances regarding its ability to set premium rates, but those assurances are for a period of only two years as opposed to a suggested term of not less than three years. The Commissioner should not approve the transfer of policies contemplated in the Amended Transaction unless he is satisfied that the assurances provided by PREMERA are sufficient to overcome the potential negative effect on subscribers.

i. **Final Report Conclusion #8.** In due course, New PREMERA will be required to obtain solicitation permits for the IPO and subsequent financing, which will have to be reviewed by the Commissioner to determine whether PREMERA has complied with applicable law. These permits are not included as part of the Original Transaction's documents, and C&B therefore cannot ascertain whether they will comply with applicable law.

j. **Supplemental Report Conclusion #8.** The Amended Transaction does not alter this FRC.

k. **Final Report Conclusion #9.** The indemnification provisions for the indemnitees of the Foundation Shareholder and the Washington Charitable Organization are far broader than the statutory provisions contained in Titles 23 and 24, WASH. REV. CODE ANN., and, because of their breadth, may not be in the public interest. Moreover, certain bylaws of the Washington Charitable Organization conflict with each other, and the Foundation Shareholder's presumption-of-assent requirement does not comply with statutory requirements. PREMERA believes that applicable law can be interpreted so as to permit what it proposes. While that may or may not be the case, the breadth of these provisions is not required by such laws. As discussed in the Final Report, on balance the public interest may be better served by narrower provisions in these areas. However, this issue is closely entwined with that of the independence of the Foundation Shareholder's governing body. Greater independence for these directors may temper the depth of concern prompted by the breadth of these protective measures.

l. **Supplemental Report Conclusion #9.** The indemnification provisions for the indemnitees of the Washington Foundation are broader than the statutory requirements, but are not of material concern because of the independence of the Washington Foundation from New PREMERA. Moreover, the Articles of Incorporation no longer conflict with the Bylaws with respect to the vote required to amend the organizational documents, although both agreements conflict with other documents. Lastly, the presumption of assent provision no longer conflicts with applicable law or with PREMERA's rationale for such a provision. The Amended Transaction has cured the issues presented in this FRC.

m. **Final Report Conclusion #10.** The Original Transaction would not be in the public interest if it provided that the Foundation Shareholder would engage in lobbying on behalf of PREMERA or Washington insurers. As currently formulated, the Original Transaction's documents permit that conclusion. PREMERA denies that it intended that result. The provision for lobbying was claimed as necessary to assure that the Foundation Shareholder would qualify as a § 501(c)(4) organization under federal tax law. However, while it might have that effect, enabling the Foundation Shareholder to lobby for purposes supported by PREMERA is not necessary for that purpose. It is possible for the Foundation Shareholder to qualify as a § 501(c)(4) social welfare organization even without requiring that it engage in substantial lobbying activities. Moreover, even if such activities are deemed desirable, they can be structured in a manner more consistent with the fundamental purposes of the Foundation Shareholder and Charitable Organizations, such as providing that the Foundation Shareholder will lobby for the interests of uninsured and underinsured populations. As is true of other related issues, independence of the Foundation Shareholder from PREMERA would mitigate these concerns as well.

n. **Supplemental Report Conclusion #10.** The concerns regarding lobbying have been mitigated substantially because the Washington Foundation is independent from New

PREMERA, and thus, concerns that the Washington Foundation will engage in activities which will benefit PREMERA are reduced. However, the Washington Foundation is prohibited from engaging in lobbying that would be materially adverse to health insurers. This provision restricts the ability of the Washington Foundation to determine the best method by which to promote its purposes. If PREMERA identifies specifically those issues on which the Washington Foundation may not lobby, then this concern may be mitigated to the extent that those issues do not raise similar concerns. Overall, PREMERA's willingness to make contributions to the Washington Foundation for lobbying purposes may not be inconsistent with the public interest to the extent that PREMERA does not influence the Washington Foundation's decisions regarding the issues on which to lobby with the use of those funds. Moreover, PREMERA has not indicated that it will fund future lobbying activities. If the IRS requests that the Articles of Incorporation be amended so as to prevent any restriction on lobbying, then it would not be contrary to the public interest to remove the lobbying restriction. A related issue is whether PREMERA should prohibit the ability of the Washington Foundation to amend its Articles of Incorporation. Despite the fact that the Articles of Incorporation permit amendments, other agreements essentially restrict that right. The lobbying issue by itself may not provide sufficient evidence to disapprove the Transaction, but may be a factor for the Commissioner to consider.

o. **Final Report Conclusion #11.** The Transaction is not in the public interest to the extent that it proposes to exempt the Foundation Shareholder's management and directors from the prudent-person standard of conduct. However, limiting such an exemption to the temporary concentration of Foundation Shareholder assets in New PREMERA stock might be appropriate under the circumstances of the Original Transaction.

p. **Supplemental Report Conclusion #11.** The exemption of the Washington Foundation's management from the codified "prudent person" rule standard for trust investments in WASH. REV. CODE ANN. §§ 11.100.010–.140, "Investment of Trust Funds," is too broad. The only exemptions from WASH. REV. CODE ANN. Chapter 11.100 that may be appropriate are as follows: (1) the 10% limit of WASH. REV. CODE ANN. § 11.100.023, (2) the duty to diversify investments under WASH. REV. CODE ANN. § 11.100.047, (3) duties under WASH. REV. CODE ANN. § 11.100.060, to the extent that PREMERA redrafts this provision to limit the exemption to any diversification requirement, and (4) the requirements of WASH. REV. CODE ANN. § 11.100.140. Although the foregoing problems alone may not be sufficient to compel disapproval, they are an additional factor to consider.

q. **Final Report Conclusion #12.** As currently written, PREMERA's and PBC's Plans of Distribution could be construed as suggesting that PBC does not hold any assets restricted to charitable, benevolent, or similar purposes. Thus, the plan documents should specify that all remaining PBC assets shall be transferred to PREMERA, on condition that those assets be used only for charitable, benevolent, or similar purposes, and on further condition that upon PREMERA's dissolution, those assets be transferred to the Foundation Shareholder. For PREMERA, similar language should be included with respect to the transfer of assets to New PREMERA. As currently written, the foregoing documents are not in the public interest to the extent that they permit transfers of assets for inconsistent purposes.

r. **Supplemental Report Conclusion #12.** In PREMERA's Plan of Distribution, PREMERA did not restrict its assets on distribution to be used for the general charitable purposes as suggested in C&B's Final Report. Instead, PREMERA has restricted the use of the assets to specific purposes, which are the same as those purposes enumerated in the Washington Foundation's Articles of Incorporation. Restricting the use of PREMERA's assets, specifically, to that enumeration is contrary to the public interest because the restriction prevents the Washington Foundation from having the flexibility to amend its purposes if deemed necessary such as when trying to achieve I.R.C. § 501(c)(4) status. Additionally, section 2(c)(iii) of the Plan of Distribution prevents PREMERA's assets from being used for "activities, programs or initiatives that likely would result in material adverse changes in the operations of entities engaged in the business of providing coverage of or the administration of health benefits, including, without limitation, any health insurer, health carrier, health maintenance organization or health plan in Washington or Alaska." This provision seems to be another inconsistency with the Washington Foundation's Articles of Incorporation because no such limitation exists in that document. And, even if there were such a restriction, it would not be in the public interest to handicap the Washington Foundation's decisions, which might ultimately be in the best interest of the public despite having an adverse effect potentially on New PREMERA. Furthermore, that provision is so broad that any activity conducted by the Washington Foundation may be considered adverse to New PREMERA. In sum, the Commissioner may have sufficient basis on these grounds to disapprove the Transaction.

s. **Final Report Conclusion #13.** In other respects, the various transfer of asset agreements appear to comply with applicable law.

t. **Supplemental Report Conclusion #13.** The Amended Transaction does not alter this FRC.

u. **Final Report Conclusion #14.** The Hart-Scott-Rodino Act probably subjects PREMERA to pre-merger notification requirements under federal law. However, the Clayton Act's substantive federal antitrust requirements probably do not apply to the Original Transaction, because PREMERA's market share immediately prior to, and after, the Transaction will be substantially the same.

v. **Supplemental Report Conclusion #14.** The Amended Transaction does not alter this FRC.

w. **Additional Supplemental Report Conclusion #15.** The Washington Foundation's Board of Directors should not be compensated. Any conflict between the Articles of Incorporation and Bylaws should be resolved to the Commissioner's satisfaction.

x. **Additional Supplemental Report Conclusion #16.** The Washington Foundation's Articles of Incorporation and Bylaws prohibit amendments, generally, without a vote of three-fourths of the directors then in office and advance written approval of the Attorney General. The requirement that three-fourths vote is required for any amendment reduces the flexibility that the Board of Directors will have in modifying these agreements to meet certain needs of the Washington Foundation. This concern may not, by itself, provide sufficient basis for disapproval of the Transaction. It is, however, an additional factor for the Commissioner to consider in making his determination.

y. **Additional Supplemental Report Conclusion #17.** PREMERA has excluded from the Washington Foundation's Board of Directors those individuals who are members "of any hospital or hospital association or medical association in Washington." This is a fundamental corporate governance question that will affect both the decisions of the Attorney General and the Commissioner. Restricting the eligibility of potential members that will serve on the Board of Directors may prevent the public from receiving the best representation available to protect its interest. The Commissioner has sufficient evidence to reject the Amended Transaction on this basis alone. At a minimum, he may consider the elimination of this provision

z. **Additional Supplemental Report Conclusion #18.** If the Attorney General finds qualified individuals to appoint to the Third Board prior to the IPO, then there is not a rational reason to compel the Second Board to make fundamental decisions regarding the IPO. The Investment Committee is to be established upon PREMERA's appointment of the First Board. The First Board, however, is intended to perform ministerial functions only, and thus, there is no need to establish the Investment Committee at that time. This provision also raises the issue of whether the Washington Foundation is independent from PREMERA. The second concern is that the level of experience required to serve on the Investment Committee is much greater than the qualifications to be a member of the Board of Directors. The Attorney General may determine that there are individuals that have sufficient business experience to serve on the Investment Committee, but do not have experience with a public company as currently required. The third concern is that the Investment Committee has the power, without approval from the Board of Directors, to determine the control, and disposition, of the Shares. This is contrary to the Washington Foundation's core function, which is to balance the health care needs of the Washington public with the maximization of the proceeds to be received from the disposition of the Shares. In the aggregate, these concerns may justify rejection of the Amended Transaction, or conditioning its approval on remedial measures.

aa. **Additional Supplemental Report Conclusion #19.** PREMERA's prohibition in its Restated Articles of Incorporation of the Washington Foundation from amending, altering, or repealing its respective Articles of Incorporation or Bylaws impedes the Washington Foundation's ability to make changes to its organizational documents in order to satisfy possible IRS concerns when trying to achieve I.R.C. § 501(c)(4) tax status. Typically when an organization seeks tax exemption from the IRS, that organization meets informally with the IRS in a pre-submission conference in order to determine what changes, if any, should be made to the organizational documents prior to the organization's formal application. If PREMERA requires that the Washington Foundation be responsible for any excise or other taxes associated with not achieving § 501(c)(4) status, then PREMERA must also give the Washington Foundation the flexibility to satisfy the requirements of the IRS. The Commissioner has sufficient evidence to reject the Amended Transaction on this basis alone.

bb. **Additional Supplemental Report Conclusion #20.** Although PREMERA has eliminated the Stock Restrictions Agreement from the Amended Transaction, PREMERA has replaced that agreement with a similar agreement entitled the Transfer, Grant, and Loan Agreement ("TGLA"). Generally, a significant portion of the agreement is either redundant, or inconsistent, with other agreements. Additionally, the TGLA inappropriately treats New PREMERA as a third-party beneficiary with the right to obtain injunctive relief. There is not a credible argument to support PREMERA's assertion that New PREMERA should be deemed a third-party beneficiary with respect to the funds expended by the Washington Foundation. Although the requirement that the Washington Foundation enter into a grant agreement in the first instance, or the specific provisions required to be included in the grant agreement, are unnecessary or inconsistent, there may not be sufficient evidence on the record to disapprove the Transaction on these bases alone. The TGLA, however, includes many of the same restrictions on lobbying and the use of proceeds that are included in the Plan of Distribution. As determined in Supplemental Report Conclusion #12, the Commissioner may have sufficient basis on those grounds to disapprove the Transaction.

4. Is the Original Transaction fair to policyholders, health care providers, and the public?

a. **Final Report Conclusion #21.** In general, the Original Transaction would fail this test if it resulted in: (1) a material deterioration in the health carrier's financial viability, (2) an increase in cost, or reduction in benefits, for coverages provided, (3) any other adverse effect on availability or affordability of health care coverage, (4) adverse impact on health care providers, (5) adverse effects on competition, or (6) failure to safeguard the public's stake in the company. While other adverse consequences of the Original Transaction are possible which would violate the applicable standards, those most commonly observed fall in these six categories. The OIC's other consultants and C&B have analyzed the Original Transaction taking these considerations into account.

b. **Supplemental Report Conclusion #21.** The Amended Transaction does not alter this FRC.

c. **Final Report Conclusion #22.** The risk that PREMERA will be deemed to have experienced a "material change in structure" and the attendant loss of tax benefits, is significant as indicated by PwC's tax analysis. Thus, the Original Transaction may not be in the public interest due to the potential negative financial impact to the company, policyholders, and public as a result of increased federal income tax liability, unless PREMERA can demonstrate other countervailing effects.

d. **Supplemental Report Conclusion #22.** Although the Amended Transaction does not alter the conclusion that PREMERA may lose certain tax benefits, the consultants have taken this potential loss into account in their analyses.

e. **Final Report Conclusion #23.** As demonstrated by PwC's economic impact analysis, there is a material possibility that the Original Transaction will have an adverse impact on premium rates or provider payments, particularly in eastern Washington, due to pressure to satisfy investor expectations. Historically, PREMERA has not fully exited unprofitable markets, though it may have reduced its writings in some cases. With the need to respond to investor expectations, PREMERA may feel compelled to discontinue unprofitable lines of business quickly and fully.

f. **Supplemental Report Conclusion #23.** PREMERA has provided assurances regarding the method by which it sets premium rates. Moreover, PREMERA has provided assurances that it will maintain a statewide PPO that meets network adequacy standards that it has developed. These assurances are for a term of only two years as opposed to the suggested term of not less than three years. The Commissioner should consider whether the assurances provided by PREMERA offset sufficiently the conclusion that PREMERA may be able to raise premium rates or decrease provider payments in eastern Washington. These assurances, however, do not offset the possibility that PREMERA may feel compelled to exit unprofitable lines of business more quickly and fully.

g. **Final Report Conclusion #24.** There is inadequate support in PREMERA's proposed uses of capital for its assertion that approving the Transaction will prevent premium increases or will prevent the reduction in provider payments which otherwise might be necessary to raise capital.

h. **Supplemental Report Conclusion #24.** Although the Amended Transaction does not alter this FRC, this conclusion does not warrant disapproval. It merely indicates that significant weight should not be given to this reason in favor of the conversion.

i. **Final Report Conclusion #25.** PREMERA's assertions, that the Original Transaction will somehow provide a substantial benefit to the company, due to an improved risk-based capital ratio or ability to fund technological initiatives, are not supported sufficiently by substantial evidence, as indicated by Blackstone's valuation analysis. In fact, significant contrary evidence exists.

j. **Supplemental Report Conclusion #25.** Although the Amended Transaction does not alter this FRC, this conclusion does not warrant disapproval. It merely indicates that significant weight should not be given to this reason in favor of the conversion.

k. **Final Report Conclusion #26.** PREMERA's outright rejection of some alternatives, such as a possible merger, causes several potential problems. First, PREMERA's arguments in favor of becoming for-profit are less persuasive. Second, the board may not have met its due diligence duties. Third, PREMERA may have forever eliminated the Foundation Shareholder's opportunity to receive a control premium. It may be that PREMERA's directors considered other alternatives. But they imposed upon this process a requirement that any transaction preserve its independence and local control. PREMERA has not offered analysis demonstrating that these conditions were necessary or desirable from the perspective of its insureds or the public. It is possible for an IPO to produce proceeds equal to the company's fair market value *under certain circumstances*, even without an explicit control premium. But PREMERA has not provided analysis demonstrating that this transaction will compensate the Foundation Shareholder for the absence of a control premium.

l. **Supplemental Report Conclusion #26.** Although the Amended Transaction does not alter this FRC, PREMERA has made some strides in the Amended Transaction with respect to transferring fair market value at the IPO. These strides, however, fall well short of what is considered the norm in prior conversions or are otherwise unfair. Moreover, any weakness in PREMERA's due diligence may not compel rejection of the Amended Transaction. However, it is a significant additional factor the Commissioner may consider in evaluating whether the Amended Transaction is in the interest of policyholders and the public.

STAGE TWO

1. Conversion-related self-dealing and conflicts of interest of PREMERA's officers and trustees:

a. **Final Report Conclusion #27.** As discussed in PwC's executive compensation analysis, PREMERA's turnover rate for management may have been more favorable than other comparable companies. PREMERA's consideration of management retention in determining whether to convert, when there was no apparent need, raises the specter of a conflict of interest. If anticipated benefits for management and employees were not necessary to address a recruiting and retention problem, the Original Transaction raises the question of whether such benefits will merely enrich recipients. If so, will such enrichment come at the expense of insureds and the public? Given the lack of supporting evidence, significant weight should perhaps not be given to PREMERA's assertion that the Original Transaction is needed to improve management retention, due to the lack of demonstrable support for such an assertion. Therefore, it is proper for the Commissioner to consider whether the conversion was motivated in fact by a desire to provide benefits to PREMERA's directors and/or management.

b. **Supplemental Report Conclusion #27.** PwC indicates that both company-wide and management voluntary turnover rates for PREMERA were lower than that of industry comparable companies. PREMERA's consideration of management retention in determining whether to convert, if there was no apparent need, could suggest a possible conflict of interest.

c. **Final Report Conclusion #28.** On October 17, 2003, PREMERA finally provided the contemplated executive compensation plans after nearly a year of requests for that information. The plans provided address benefits for two years after implementation of the conversion, but provide no guidance as to benefits to be accorded management or directors after that date. The terms of the transaction as proposed as of October 15, 2003, effectively leave the terms of subsequent plans in the hands of PREMERA and its successors, but not the Foundation Shareholder as the single largest shareholder of New PREMERA. Of course, the date of submission came after the deadline for amendment of the Form A. In fact, the plans were provided too late to permit complete analysis. Evaluation of those plans is necessary in order to determine whether they are contrary to the public interest in that they enrich management or the board at the expense of insureds and the public. Due to PREMERA's failure to provide these plans prior to the October 15, 2003, date to amend the Form A, and because the plans only address the two-year period following the conversion, C&B and the other consultants cannot express a conclusion as to whether, these plans present a conflict of interest, or are otherwise contrary to the public interest or the interest of policyholders and insureds. As discussed in Stage One, a strong argument can be made that the Form A is incomplete without these plans.

d. **Supplemental Report Conclusion #28.** The Consultants have received and reviewed management's executive compensation plans. It will be necessary to determine whether anticipated management benefits present a conflict of interest of sufficient magnitude to make the Amended Transaction contrary to the public interest. PREMERA has included certain limitations and safeguards which mitigate to some degree the amount of additional compensation that management and directors stand to gain immediately after the conversion. The Commissioner should factor these assurances into his consideration as to whether the Amended Transaction was motivated by some consideration other than the best interest of the company. It should be noted, however, that there may not be sufficient evidence on the record to support the disapproval of the Transaction on this basis alone.

2. The independence of the Foundation Shareholder and Charitable Organizations on the one hand and PREMERA on the other hand:

   a. **Final Report Conclusion #29.** The Foundation Shareholder, which is to receive initially the consideration to be conveyed to the public, is far from independent from PREMERA. Indeed, it is probable that the Foundation Shareholder will be subject to substantial influence or control by PREMERA and that, at least some of, its activities will be conducted for PREMERA's benefit. The proposed inclusion of "Independent Directors" does not alter this FRC because they will not in fact be independent; they will be PREMERA nominees consisting of: (1) PREMERA's, PBC's, or their predecessors' current or former board members, or (2) individuals nominated by PREMERA and elected or appointed by a majority vote of the "Independent Directors."

   b. **Supplemental Report Conclusion #29.** The Amended Transaction provides for the Washington Foundation to be independent from New PREMERA. However, through PREMERA's restrictions on lobbying, and its funding of lobbying activities, PREMERA may retain some indirect influence on the Washington Foundation. Moreover, the appointment of the Investment Committee at the time the First Board is installed may raise an additional independence issue. Although the Commissioner may not be able to justify disapproval of the Transaction on this basis alone, he may consider this as an additional factor in his decision.

   c. **Final Report Conclusion #30.** The proposal that the Foundation Shareholder be authorized to lobby for certain health care issues may result in efforts to utilize the Foundation Shareholder for PREMERA's benefit. The Original Transaction contains no safeguard against this possibility.

   d. **Supplemental Report Conclusion #30.** *See* Supplemental Report Conclusion #29.

3. The stock transfer documents and the related transfer of PREMERA's fair market value:

   a. **Final Report Conclusion #31.** The Stock Governance Agreements contain substantial restrictions, which individually or in combination, have the effect of undermining the required transfer of PREMERA's fair market value to the

Foundation Shareholder. These agreements are as follows: (a) the Stock Restrictions Agreement, (b) the Voting Trust and Divestiture Agreement, (c) the Registration Rights Agreement, (d) the Stockholder Protection Rights, (e) the Excess Share Escrow Agreement, and (f) the Indemnification Agreement. Some of the more egregious restrictions have been identified in C&B's Final Report and in Blackstone's valuation analysis.

b. **Supplemental Report Conclusion #31.** The Stock Governance Agreements in the Amended Transaction eliminate the Indemnification Agreement, the Stock Restrictions Agreement, and the Stockholder Protections Agreement. The Stock Restrictions Agreement was replaced with a similar agreement known as the Transfer, Grant, and Loan Agreement. Moreover, the Unallocated Shares Escrow Agreement was added to deal with a situation in which the states do not agree on an allocation of the Shares.

c. **Final Report Conclusion #32.** The Stock Restrictions Agreement does not provide for an allocation of PREMERA's assets between the states of Washington and Alaska. Without such an allocation, fair market value will not have been transferred.

d. **Supplemental Report Conclusion #32.** *See* Supplemental Report Conclusion #42.

e. **Final Report Conclusion #33.** The Voting Trust and Divestiture Agreement compels the Foundation Shareholder to divest its Shares according to a predetermined schedule over a five-year period, without regard to the effect of this schedule on the interests of the Foundation Shareholder or the Charitable Organizations. Typically, provisions that compel a stockholder to divest its shares pursuant to a predetermined schedule can have a negative effect on the value of that stock, because those shares are not freely tradeable. Thus, the Foundation Shareholder will not have the ability to sell only when it deems doing so to be optimal. To that extent at least, such restrictions are not in the public interest. Moreover, the Foundation Shareholder will be required to transfer its voting rights in its Shares to New PREMERA, depriving it of any control over the company of which it will be the largest shareholder and which, at least initially, will be the Foundation Shareholder's largest asset.

f. **Supplemental Report Conclusion #33.** As a general matter, there is no reason to treat the Foundations as a single shareholder when analyzing the VTDA. The VTDA is problematic because of provisions relating to divestiture, the number of shares held outside the voting trusts, voting of the Shares, the nomination, election, and term of the Designated Member, and the termination of the VTDA upon the termination of the License Agreement or elimination of the restrictions and licensing conditions. The divestiture schedule purports to treat the two Foundations as a single shareholder by aggregating the shares that are required to be sold in order to satisfy each deadline. Each of the Foundations should have the right to hold 5% of the shares outside of the voting trust without subjecting such provision to the BCBSA's approval. The VTDA should allow the Washington Foundation to vote on major corporate transactions which result in more than 20% of the outstanding shares being exchanged. The Washington Foundation should have the ability to vote on any new SOP that is effective after the Stock Restrictions Period, but submitted to a shareholder vote during the first two and one-half years of that period. Moreover, the Washington Foundation has a significant interest in ensuring that the Independent Directors do not have any direct or indirect material relationship with New PREMERA, because the Independent Directors will be controlling the voting of the Shares on many issues. Blackstone believes that the qualifications for Independent Directors are not stringent enough because a director could be considered independent even if another company that employs that director receives approximately $57 million in PREMERA revenues. The Designated Member is to be appointed by the Foundations jointly. In order to safeguard its economic interest, the Washington Foundation, as a large majority shareholder, should have its own representation on the New PREMERA board. The right to appoint the Designated Member should not be limited to five years, because the Washington Foundation could potentially still have a significant shareholding at that time. PREMERA should not have a right to veto all of the Washington Foundation's Designated Member candidates on grounds other than that the candidate does not meet the qualifications to be a board member as required in New PREMERA's organizational documents. There is not a well-reasoned rationale that the VTDA should be maintained if the License Agreement (or its requirement for the restrictions at issue) is terminated. PREMERA should memorialize the transfer of the Class B share from New PREMERA to the Washington Foundation.

g. **Final Report Conclusion #34.** The proposed requirement that the Foundation Shareholder be liable, at least in part, for the expenses or compensation of the Trustee, and the obligation that it indemnify the Trustee, may be contrary to the interests of the public. The Trustee's services would not be required at all if PREMERA paid its fair market value to the Foundation Shareholder in cash on the effective date of the Transaction. Moreover, control of the Foundation Shareholder by PREMERA has the effect of requiring the public assets to indemnify PREMERA for its own conduct.

h. **Supplemental Report Conclusion #34.** A provision has been included that the Foundations and New PREMERA each pay for the Trustee's expenses equally, which is a fair proposition as compared to precedent transactions. However, the trustee's expenses should be borne fully by PREMERA because it is imposing upon the Washington Foundation unnecessary conditions.

i. **Final Report Conclusion #35.** The lack of independence envisioned in the Registration Rights Agreement undermines the public interest to the extent that

PREMERA retains effective control of such matters as pricing, underwriter discounts, commissions, and hold-backs.

j. **Supplemental Report Conclusion #35.** The Registration Rights Agreement ("RRA") is of concern because the underlying demand rights were apportioned between the states upon the assumption that each state would be subject to a separate divestiture schedule. Those allotments may be problematic to the extent that the Washington Foundation would now have added pressure to sell its Shares. Moreover, Blackstone believes that if the Washington Foundation piggy-backs on New PREMERA's demand, then the Washington Foundation should have the right to continue a registration even if New PREMERA has terminated its participation. Additionally, the RRA's requirements regarding the indemnification of New PREMERA is unnecessary or far too broad.

k. **Final Report Conclusion #36.** The proposed Purchase Option for PREMERA deprives the Foundation Shareholder of investment flexibility to a degree that may further undermine the value of the stock ostensibly conveyed for the benefit of the public.

l. **Supplemental Report Conclusion #36.** PREMERA has eliminated the Purchase Option. This issue is no longer a concern for C&B.

m. **Final Report Conclusion #37.** The Stockholder Protection Rights Agreement may have the effect of further entrenching management, contrary to the public interest.

n. **Supplemental Report Conclusion #37.** PREMERA has eliminated the Stockholder Protection Rights Agreement. This issue is no longer a concern for C&B.

o. **Final Report Conclusion #38.** The Indemnification Agreement unfairly places the entire burden of potential tax consequences and other liabilities, as a result of the Transaction, on the Foundation Shareholder. There is no reasonable justification for requiring the Foundation Shareholder to indemnify PREMERA with respect to any potential tax consequences or other liabilities. PREMERA is the applicant that has initiated this Transaction, and the Foundation Shareholder is unlikely to have any influence on the events potentially giving rise to a liability indemnifiable under the agreement.

p. **Supplemental Report Conclusion #38.** PREMERA has eliminated the Indemnification Agreement. This issue is no longer a concern for C&B.

q. **Final Report Conclusion #39.** Due to the lack of productive use of the capital that PREMERA proposes to raise, the value transferred to the Foundation Shareholder may be diluted by as much as 15% according to Blackstone. This dilution results in a transfer of less than fair market value and is not in the public interest for this reason.

r. **Supplemental Report Conclusion #39.** PREMERA has provided for Blackstone to issue an IPO Procedures Opinion which will address the amount stock that should be sold at the IPO. However, the Washington Foundation will not have access to the underlying information for this opinion when making the determination of how much stock to sell at the IPO. Because the IPO Procedures Opinion does not adequately protect the Washington Foundation's economic interest, it should be allowed to appoint a joint book running manager.

s. **Final Report Conclusion #40.** The initial shares at an IPO are typically sold at a discount from fair market value. To the extent that PREMERA requires the Foundation Shareholder to sell shares at the IPO, PREMERA should compensate the Foundation Shareholder for the lower value received by the Foundation Shareholder.

t. **Supplemental Report Conclusion #40.** *See* Supplemental Report Conclusion #3.

u. **Additional Supplemental Report Conclusion #41.** The Unallocated Shares Escrow Agreement generally causes concern because if the uncertainty as to the proper allocation of the Shares among the states is of sufficient magnitude, placing the amount as to which there is uncertainty in the escrow might impair substantially the ability of the Foundations to make sufficiently informed decisions as to how to sell the stock allotted to them. Moreover, the agreement causes concern with respect to: (1) a requirement that the Foundations sell an aggregate of 10% of New PREMERA's outstanding stock in the IPO, (2) expenses, indemnification, and selection of the escrow agent, and (3) voting rights.

v. **Additional Supplement Report Conclusion #43.** The License Agreement is unnecessary because there is no compelling reason for the Foundations to use the Trademarks. Regardless of the necessity, the agreement should be revised to eliminate unintended or undesirable liabilities and obligations.

This summary of the Supplemental Report identifies significant issues raised by the Amended Transaction as described in the Amended Form A, supporting documents, and PREMERA's communications. Each issue is potentially complex and susceptible of divergent consequences under differing circumstances. It is impossible to predict with specificity and certainty how PREMERA will actually conduct its business following implementation of the Amended Transaction.

PREMERA has amended its Original Form A in a manner that could be found by the Commissioner to address satisfactorily, or to reduce concern about, many, but not all, of the issues identified by C&B and the other consultants. The Amended Transaction, thus, results in a narrowed list of issues upon which the Commissioner can focus his attention. It is possible that the number of issues outstanding has been reduced sufficiently that the Commissioner, if he so chooses, may condition approval upon PREMERA's satisfaction of specified conditions as he deems appropriate. On the other hand, the Commissioner could reject the Amended Transaction outright based on PREMERA's failure to address these problems satisfactorily.

In sum, PREMERA has made significant progress in addressing, or lessening, many of the OIC's and its consultants' concerns. However, as the OIC and its consultants delved further into the details of PREMERA's proposed conversion, as well as the intricacies involved between the states, it has become readily apparent that PREMERA's solution for some of the issues identified previously resulted in the creation of additional issues. This is not to say that the remedies were ill-advised, but merely to note that, as is often the case in transactions of this complexity and magnitude, the modification of one aspect of a transaction may affect other aspects of the transaction. As has been true in prior conversions, many times documents comprising the Form A are modified substantively several times prior to being approved. PREMERA's proposed conversion in the State of Washington is not an exception from this observation. Actually, the prospect that issues would be uncovered once discussions began was one of the very real possibilities that existed as a result of postponing these discussions until after the consultants' initial reports were submitted on October 27, 2003. To be sure, this should come as no surprise to PREMERA.

As early as February 2003, the regulators informed PREMERA that their preliminary review of the Original Transaction had revealed several "Structural Issues" inherent in the proposed conversion which were of substantial concern in the context of the applicable statutory standards. The Structural Issues were viewed as so material or significant as to warrant communicating them to PREMERA before the analyses of the regulators and consultants were complete. The intent of that communication was to enable PREMERA to reevaluate certain elements of the Original Transaction early in the review process. PREMERA was thus provided an opportunity to revise elements of the conversion giving rise to the Structural Issues or other matters, so that these revisions could be incorporated in the consultants' review early in the process, and that issues which arose as a result of these revisions could be evaluated. Moreover, and perhaps more importantly, in the absence of satisfactory responses to the Structural Issues, PREMERA was given notice that a substantial probability existed that the regulators or the consultants would conclude that the Original Transaction did not comply fully with applicable legal requirements. Although the Structural Issues were provided orally to PREMERA near the end of February 2003, PREMERA's approach was to wait to conduct these discussions until after the consultants' reports were made public ten months later. Because PREMERA had not revised the Original Transaction in response to the Structural Issues, the Final Report was based on the Original Transaction's structure as of the latest, amended Form A, dated October 25, 2002. C&B and the other consultants did not attempt to analyze a hypothetical transaction which had not been proposed by PREMERA.

One Structural Issue of particular relevance identified in February 2003, and in C&B's Final Report, was whether PREMERA's stock was to be conveyed directly to one foundation, with the proceeds when sold to be distributed to two charitable organizations corresponding to separate states, or whether the stock was to be conveyed directly to the two separate organizations. The Original Transaction reflects the prior structure, whereas the Amended Transaction reflects the latter. As will be seen in the Supplemental Report, this revised structure requires that the two separate foundations, representing Washington and Alaska, have rights as separate shareholders. PREMERA, however, has structured the Amended Transaction as if Washington and Alaska are a single stakeholder, which of course they are not. For example: (1) the Foundations must serve the needs of separate communities, (2) the people of two <u>different</u> states are vying for PREMERA's assets, (3) directors for the Foundations will be appointed by officials in the two separate states, and (4) each state must address different interests, affected constituencies, and political considerations. These factors taken as a whole lead to the inescapable conclusion that two separate stakeholders are indeed involved in this conversion, and there is no rational reason to treat them as a single shareholder.

In any event, C&B has identified problems that were ascertainable both at the time of C&B's Final Report and those that became apparent during discussions with PREMERA over the last few months. As noted previously, C&B believes that, given the array of issues still outstanding the Commissioner might approve the Transaction only subject to the satisfaction of certain conditions, or disapprove the conversion in its entirety.

Respectfully,

CANTILO & BENNETT, L.L.P.

Enclosures

SUPPLEMENTAL REPORT
OF
CANTILO & BENNETT, L.L.P.

February 27, 2004

An analysis of the

FORM A

STATEMENT REGARDING THE ACQUISITION OF CONTROL
OF A DOMESTIC HEALTH CARRIER AND A DOMESTIC INSURER

Premera Blue Cross, LifeWise Assurance Company, LifeWise Health Plan of Washington, LifeWise Health Plan of Oregon, Inc., Premera Blue Cross Blue Shield of Alaska, and LifeWise Health Plan of Arizona, Inc. direct or indirect affiliates of

PREMERA

BY

[New PREMERA Corp.]

Filed with the Insurance Commissioner of the State of WASHINGTON, the ALASKA Division of Insurance, and the OREGON Insurance Division

Dated: February 5, 2004

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SUPPLEMENTAL REPORT OF CANTILO & BENNETT, L.L.P.

I. INTRODUCTION

CANTILO & BENNETT, L.L.P. ("C&B") has been engaged by the Office of the Insurance Commissioner of the State of Washington (the "OIC") to assist in the evaluation of a proposal by the Premera Group ("PREMERA") to convert from nonprofit to for-profit, in part by changing the ultimate controlling entity of PREMERA's members, which are regulated by the Insurance Commissioner of the State of Washington (the "Commissioner") pursuant to WASH. REV. CODE ANN §§ 48.01.0100–.120.025 (West, WESTLAW through Chapter 1 of 2004 Regular Session) ("Washington Insurance Code"). PREMERA had filed its proposal originally on September 17, 2002, as amended on October 25, 2002 (the "Original Form A"). On October 27, 2003, C&B submitted it analysis of the Original Transaction ("C&B's Final Report" or the "Final Report") as part of its initial engagement with the OIC (the "Original Engagement"). On December 11, 2002, and on January 9, 2003, the Commissioner extended the case schedule in order to permit PREMERA to discuss with the OIC the concerns of the OIC and its consultants with respect to the Original Transaction. C&B was then engaged (the "Supplemental Engagement") to submit this report (the "Supplemental Report") based on its analysis of any changes PREMERA incorporated in the resulting amended Form A, which was eventually filed on February 5, 2004 (the "Amended Form A"). PREMERA's currently proposed conversion shall be referred to as the "Transaction" or the "Amended Transaction," and PREMERA's proposed transaction, as of the date of C&B's Final Report, shall be referred to as the "Original Transaction." For ease of reference, C&B will mirror the Final Report's format within this Supplemental Report, to the extent practicable.

C&B's engagement with respect to the Final Report, as formulated initially, contemplated that the Original Transaction's review would occur in two distinct phases, identified as "Stage One" and "Stage Two." Separate aspects of the Original Transaction were expected to be reviewed in each phase. For a variety of reasons as discussed in the Final Report, the areas considered in the two phases of the review substantially overlap. Thus, several matters envisioned originally as part of Stage Two were evaluated as part of Stage One. Moreover, since the Final Report, additional Stage Two issues that were not analyzed fully due to the lack of information, have been analyzed within this Supplemental Report. Because the Amended Transaction's structure has fundamentally changed, C&B has modified the Stage One and Stage Two assignments analyzed in this Supplemental Report to the extent required to conduct an analysis comparable to that which was conducted in the Final Report.

As part of Stage One assignments, C&B provided an analysis and opinion as to the following: (1) whether PREMERA has complied with the appropriate change of control filing requirements, (2) whether the Amended Transaction is economically viable, (3) whether PREMERA has complied with the Washington Insurance Code, Washington Administrative Code ("WASH. ADMIN. CODE") provisions, WASH. REV. CODE ANN. Title 24 ("Washington Nonprofit Corporation Act"), and certain provisions of federal law, and (4) whether the Amended Transaction is fair to policyholders, health care providers, and the public. In addition, C&B has analyzed the following

Stage Two assignments: (1) the conversion-related self-dealing and conflicts of interest of PREMERA's officers and trustees, (2) the independence of the Washington Foundation[1] on the one hand, and PREMERA on the other hand, and (3) the stock transfer documents and the related transfer of PREMERA's fair market value.

This Supplemental Report should be read together with the summary with which it is submitted (the "Executive Summary"), the Final Report submitted previously on October 27, 2003 (the Supplemental Report, Executive Summary, and Final Report are referred to collectively as "C&B's Analysis"), and the reports submitted by other consultants to the OIC. The Executive Summary's terms and conditions are hereby expressly incorporated into this Supplemental Report. C&B has not analyzed the extent to which portions of this Supplemental Report are confidential under applicable law. The report is divided into five sections. This first section introduces the Supplemental Report and includes a summary of the Supplemental Engagement. Section II provides background information regarding the Amended Transaction and C&B's Analysis. Section III provides an analysis of the Stage One issues as they apply to the Amended Transaction. Section IV provides an analysis of the Stage Two issues as they apply to the Amended Transaction. Section V summarizes the conclusions developed in this Supplemental Report. Section V presents a general recommendation regarding the Amended Transaction. Moreover, throughout this Supplemental Report, reference will be made to the Final Report's conclusions, and how, if at all, those conclusions have changed as a result of the Amended Transaction.

II. BACKGROUND

A. History of the Blue Cross and Blue Shield Industry

The roots of the "Blue Cross movement" are widely attributed to the efforts of Texan, Justin Ford Kimball, aimed at preventing the near collapse of University Hospital in the 1920s. In 1929, he devised and implemented one of the first, if not the first, prepaid hospital services programs, enabling Dallas, Texas, school teachers to pay 50 cents per month for basic hospital care. This program, in turn, became the first Blue Cross plan. The model was quickly copied throughout the country and was soon followed by comparable "Blue Shield" programs for prepaid physician services.[2] Over the years, more than a hundred such plans evolved, all nonprofit. In due course, a Blue Cross Association and a Blue Shield Association were formed. By the mid 1980s, a wave of consolidations of the Blue Cross and Blue Shield plans emerged in many markets, though many had

[1] With respect to the second assignment of Stage Two, the Final Report refers to the Foundation Shareholder and Charitable Organizations rather than the Washington Foundation because PREMERA had not at that time replaced the Foundation Shareholder and Charitable Organizations with the Washington Foundation and the Alaska Foundation. In addition, for reasons that are not apparent, PREMERA refers to the Washington Foundation as the "Washington Foundation Shareholder." The structure of the Amended Transaction does not bifurcate the foundation functions between a shareholder and a charitable organization, as had the Original Transaction. C&B will therefore refer to this entity as the Washington Foundation, not the Washington Foundation Shareholder. The terms Foundation Shareholder, Charitable Organizations, Washington Foundation, and Alaska Foundation are defined later in this Supplemental Report.

[2] *The Blues—A History of the Blue Cross and Blue Shield System*, Robert Cunningham III and Robert M. Cunningham, Jr., Northern Illinois University Press, 1997.

in fact been managed jointly more or less since their inception in the 1930s and 1940s. In fact, in 1982, the Blue Cross Association and the Blue Shield Association themselves had merged.

During the ensuing decades, these plans achieved significant, if not dominant, market positions in the regions they served. The Blue Cross and Blue Shield marks were registered and became one of the most recognized trademarks in the country (some say second only to Coca Cola). The companies experienced a number of cycles of profitability and economic challenge, but by the 1990s it became evident that many had become valuable insurers. Lured perhaps by the ability to "cash in" on this long-developed franchise, in 1994, the Blue Cross Blue Shield Association (the "BCBSA") amended its rules to permit its members to become for-profit insurers. Others may argue that Congress' repeal in the mid 1980s of certain tax benefits, which were given historically to BCBS companies, was the primary driver of the BCBSA's amendment of its rules. In any event, a wave of conversions was launched promptly with the creation of WellPoint Health Networks, Inc., from what had been Blue Cross of California.

As of the date of this report, there has been a wide variety of reorganizations, conversions, mergers, and acquisitions, reducing the industry to 41 individual plans. Appendix II lists the major transactions comprising this wave of conversions. Common to most conversions has been the recognition that the companies (or at least some portion thereof) constituted public assets, for the conversion of which the citizens of the state must be compensated. Typically, that compensation has taken the form of charitable trusts or foundations.[3] Early disagreement about the need for such compensation has given way to more focused debate over the details of how it should be conveyed. Against this backdrop, PREMERA filed its Original Form A on September 17, 2002, as amended on October 25, 2002. In the case before the Commissioner, there did not appear initially to be a disagreement as to whether PREMERA must deliver to the citizens of the states of Washington and Alaska aggregate compensation equaling the company's fair market value.[4] PREMERA, however, contested this apparent understanding between the parties near the time of the filing of C&B's Final Report. Nonetheless, as was demonstrated previously in C&B's Final Report and as will be seen again, PREMERA is obligated to transfer the fair market value, and thus, many of the issues in this Supplemental Report concern how that is to be accomplished.

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[3] There have been exceptions. The merger of the Texas and Illinois plans was ruled, after extensive litigation, not to trigger a charitable trust obligation. *Abbott v. Blue Cross Blue Shield of Tex., Inc.*, 113 S.W.3d 753 (Tex. App. 2003). In some cases, the proceeds have gone to state treasuries, rather than charities. *See*, for example, the conversion of Trigon BCBS in Virginia.

[4] While PREMERA purports not to concede that applicable law requires conveyance of its fair market value to charitable organizations, it asserts that the transaction accomplishes that very same result. For example, the Original Form A states at p. 5 that PREMERA will distribute 100% of its assets to the Washington Foundation and the Alaska Foundation. In PREMERA's response on October 15, 2003, to C&B's draft of the Final Report, addressing this very issue, PREMERA asserts that it "*has agreed only that it will transfer 100% of its stock to the Foundation Shareholder, which represents the fair market value of the company upon consummation of the conversion transaction.*"

B. PREMERA's Current Organizational Structure

PREMERA, a nonprofit miscellaneous company, is a holding company that wholly owns Premera Blue Cross ("PBC"), a Washington nonprofit health care service contractor.[5] PBC transacts business as a health care service contractor in Washington and Alaska. Additionally, of the companies within PREMERA's structure, PBC is the primary operating subsidiary and is licensed by the BCBSA to use the Blue Cross and Blue Shield names and trademark (the "Mark") in various parts of the state.[6] Furthermore, PBC wholly owns the following subsidiaries: (1) PremeraFirst, Inc. ("PremeraFirst"), an agent for contracting with providers, (2) Washington-Alaska Group Services, Inc. ("WAGS"), an insurance sales agency, (3) LifeWise Healthplan of Arizona, Inc. ("LifeWise of Arizona") (known at the time of the Original Form A filing as MSC Life Insurance Company), a Washington for-profit insurance company, and (4) Premera Blue Cross Blue Shield of Alaska ("PBC-AK"), an Alaska for-profit insurance company.[7]

WAGS, in turn, wholly owns the following subsidiaries: (1) LifeWise Health Plan of Washington ("LifeWise of Washington"), a Washington nonprofit health care service contractor, (2) LifeWise Assurance Company ("LifeWise Assurance") (known at the time of the Original Form A filing as States West Life Insurance Company), a Washington for-profit insurance company, (3) LifeWise Health Plan of Oregon, Inc. ("LifeWise of Oregon"), a for-profit insurance company organized in the State of Oregon ("Oregon"), (4) LifeWise Administrators, Inc. ("LifeWise Administrators"), a Washington for-profit company that provides billing and collection services to its affiliates, (5) Calypso Healthcare Solutions, Inc. ("Calypso") (known at the time of the Original Form A filing as Quality Solutions, Inc.), a Washington nonprofit company that provides investigation and recovery services to health plans and self-funded employer benefit plans, and (6) NorthStar Administrators, Inc. ("NorthStar"), a Washington for-profit, third-party administrator. LifeWise of Oregon wholly owns Western Benefits Administrators, Inc. ("WBA"), an inactive Oregon for-profit corporation.[8] LifeWise of Oregon and WBA, which are domiciled in Oregon, are the only subsidiaries domiciled outside of Washington.[9]

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[5] Overview of New PREMERA Operations and Strategy and Rationale for Conversion, Form A: Exhibit E-7, at 8 (Oct. 18, 2002), *available at* http://www.insurance.wa.gov/special/premera/filing/Exhibit_E7_10-18-02-redacted.pdf [hereinafter "Business Case, Form A: Exhibit E-7"].

[6] *Id.* at 8–9. In 1994, PBC affiliated, and later merged, with Medical Service Corporation of eastern Washington, and thereby, obtained the right to use the Blue Shield trademark in most of the counties in eastern Washington.

[7] PREMERA's Current Organizational Chart, at 0037553 (Sept. 3, 2003) (the certificate of authority for PBC-AK was issued subject to PREMERA's satisfaction of certain conditions in the Amended Form A) (on file with C&B).

[8] *Id.*

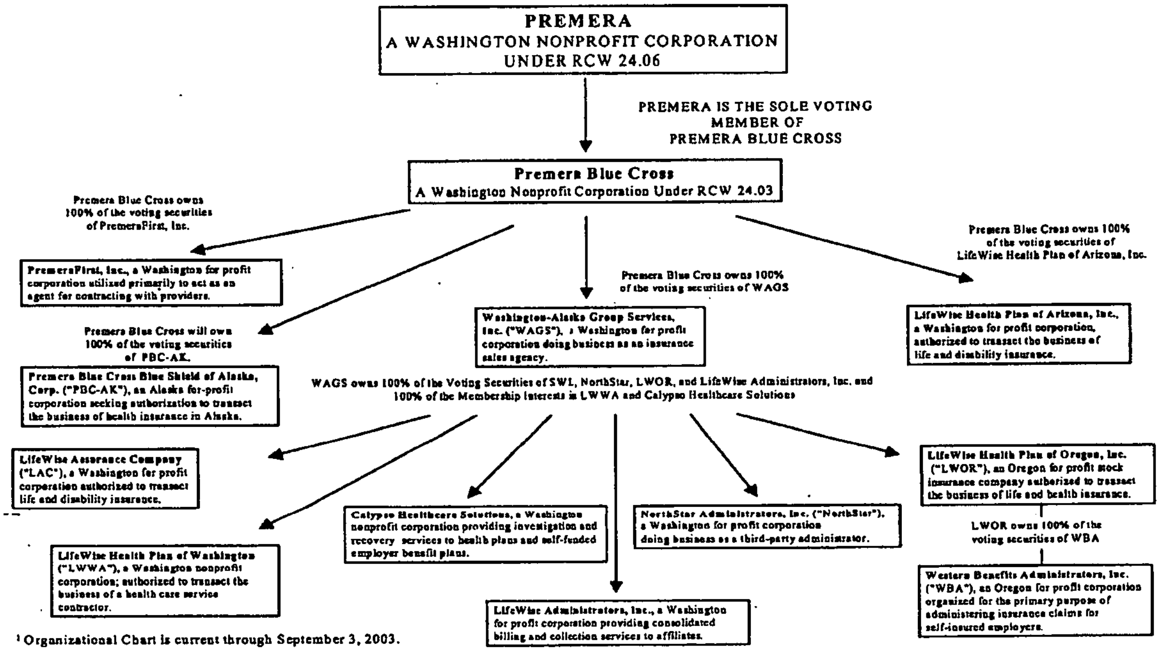
[9] *Id.*

The nonprofit health care service contractors domiciled in Washington are PBC and LifeWise of Washington (the "Nonprofit Health Carriers").[10] PREMERA and Calypso are both nonprofit corporations that are neither health care service contractors nor insurers.[11] The for-profit subsidiaries are: (1) PremeraFirst, (2) WAGS, (3) LifeWise Assurance, (4) LifeWise of Arizona, (5) LifeWise Administrators, (6) NorthStar, (7) WBA, (8) LifeWise of Oregon, and (9) PBC-AK.

As provided by PREMERA, its organizational chart, as of September 3, 2003, is as follows:

Exhibit A

Organizational Chart[1]



[1] Organizational Chart is current through September 3, 2003.

As of October 31, 2002, PREMERA is licensed in Oregon, Alaska, and Washington.[12] PBC is licensed in Washington and Alaska.[13] WAGS is licensed in Washington, Alaska, Oregon, and

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[10] *Id.* Pursuant to certain sections of the Washington Insurance Code, health care service contractors are also known as domestic health carriers.

[11] Business Case, Form A: Exhibit E-7, *supra* note 5, at 8, 10.

[12] PREMERA, List of States Where PREMERA and Its Affiliates Have Been Licensed or Qualified to Do Business In, at 0000002 (Oct. 31, 2002) (on file with C&B).

[13] *Id.*

Arizona.[14] LifeWise Assurance is licensed in Washington, Oregon, Alaska, Arizona, California, Idaho, Montana, New Mexico, North Dakota, Utah, and Wyoming.[15] Calypso is currently licensed in Washington and New Jersey.[16] NorthStar is licensed in Washington, Alaska, and Oregon.[17] LifeWise of Oregon is licensed in Oregon and Idaho.[18] PremeraFirst is licensed in Washington and Oregon.[19] WBA is not licensed in any state.[20] LifeWise of Washington and LifeWise Administrators are licensed only in Washington.[21] LifeWise of Arizona does business only in Arizona. PBC-AK is not yet licensed in Alaska.

C. Brief Description of the Amended Transaction

The applicant[22] proposes to acquire control of PREMERA and its direct and indirect affiliates. As a result of the Amended Transaction, the Nonprofit Health Carriers will essentially convert to for-profit companies,[23] in a series of transactions through a process that can be described briefly as follows: (1) PBC will convert into New Premera Blue Cross Corp. ("New PBC"), and (2) LifeWise of Washington will convert into New LifeWise Health Plan of Washington ("New LifeWise of Washington"). The other two nonprofit companies, PREMERA and Calypso, will also convert into New PREMERA, Inc. ("New PREMERA") and New Calypso Healthcare Solutions, Inc.,[24] respectively. In addition, PBC's assets related to its operations in Alaska will be used initially to fund PBC-AK, a corporation formed recently as part of the Amended Transaction. Through a series of transactions, PBC-AK's shares will be transferred to New PREMERA, and thus, New PBC

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[14] *Id.*

[15] *Id.* When this list was compiled, LifeWise Assurance was known as States West Life Insurance Company.

[16] *Id.* Calypso was known at the time of this list's preparation as Quality Solutions.

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] *Id.*

[22] As to the applicant's identity under Washington law, *see infra* at section III.A.2 ("Disclaimer of Control"). For purposes of this discussion, New PREMERA, and not the Foundations (as both terms are defined later in this section), will be considered the applicant.

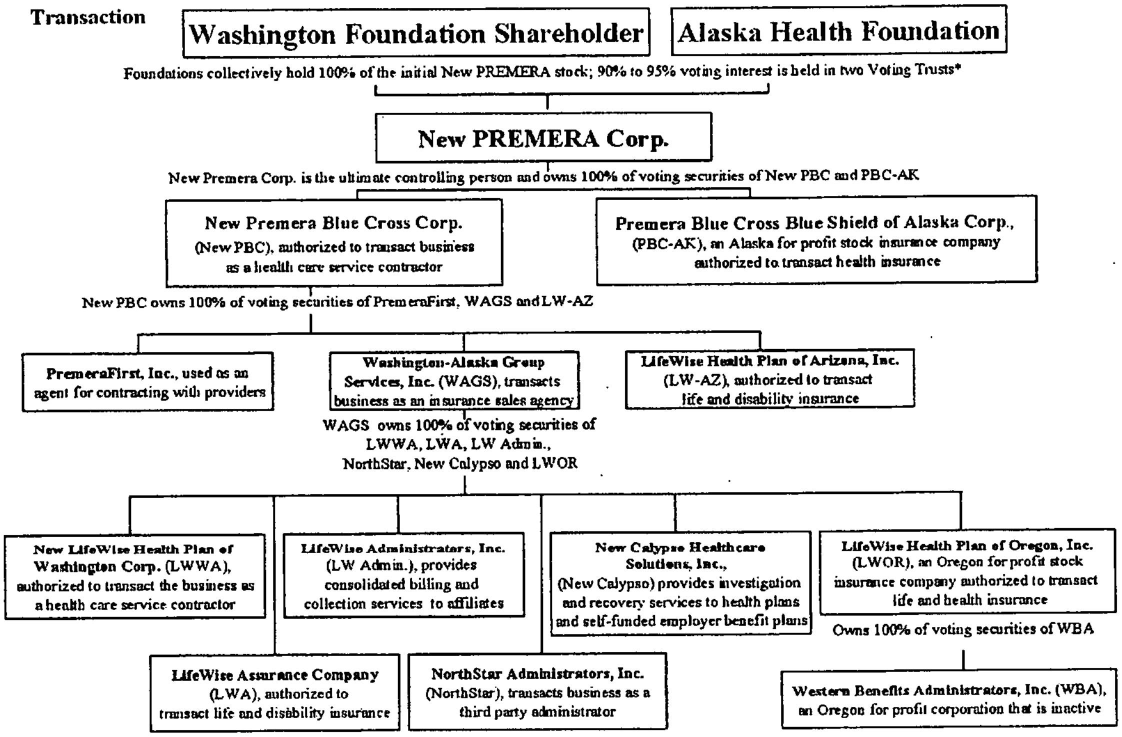
[23] The term "convert," with respect to the Transaction, does not signify a specific legal statutory framework for converting from a nonprofit insurer to a for-profit insurer, because such a framework does not exist in the State of Washington. Rather, the term "convert," with respect to the Transaction, refers to the series of dissolutions and transfers of assets, whereby PREMERA is attempting to achieve a result similar to a conversion.

[24] Although the Amended Form A does not directly address the conversion of Calypso, Exhibit B-3 of the Amended Form A indicates that Calypso would also convert to a for-profit company.

and PBC-AK will both be wholly-owned subsidiaries of New PREMERA.[25] As a result of the Amended Transaction, [Washington Foundation Shareholder],[26] a Washington nonprofit corporation (the "Washington Foundation") and the [Alaska Health Foundation,] an Alaska nonprofit corporation (the "Alaska Foundation") (as noted above, the two foundations are referred to collectively as the "Foundations") will receive 100% of New PREMERA's outstanding shares (the "Shares"). If the Amended Transaction is approved, PREMERA's corporate organizational chart immediately after the approval will be as follows:

Organizational Chart Post Conversion Transaction

Exhibit B-3



* Foundation Shareholders and the Trustee of the Voting Trusts have submitted a disclaimer of ultimate control.
** Unless otherwise noted, all entities are Washington corporations under Chapter 23B RCW.

The Original Transaction had contemplated that one [Foundation Shareholder], a Washington nonprofit corporation, would receive the Shares for distribution to [Washington Charitable Organization], a Washington nonprofit corporation (the "Washington Charitable Organization"), and [Alaska Charitable Organization], an Alaska nonprofit corporation (the "Alaska Charitable Organization") (the two charitable organizations are referred to collectively as the "Charitable Organizations"). However, in response to the OIC's and its consultants' concerns, and for a variety

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[25] PREMERA has restructured this aspect of the Original Transaction in order to make both New PBC and PBC-AK wholly-owned subsidiaries of New PREMERA, in part so that New PREMERA will be able to provide certain financial guarantees to each, as will be discussed *infra* at section III.C.1.b.

[26] Names in brackets signify that PREMERA has not yet designated a specific name for the entity.

of other reasons, as discussed throughout this Supplemental Report, PREMERA abandoned this structure in favor of the structure set forth in the Amended Transaction. The other fundamental structural change is that PBC-AK will now be a wholly-owned subsidiary of New PREMERA rather than PBC. The primary purpose of this change is so that New PREMERA will be able to provide certain guarantees to both entities as discussed *infra* at section III.C.1.b.

New PREMERA contemplates that additional shares will be issued for sale to the public in an initial public offering (the "IPO"). The proceeds from the sale of those new shares would be realized by New PREMERA, constituting the initial new capital that the Amended Transaction is designed to raise. Once New PREMERA becomes a publicly-traded company, the Foundations, pursuant to various agreements, will sell a portion of their Shares in the public market at the IPO, and in secondary offerings, and will devote the proceeds to the benefit of the public as outlined in their organizational documents. The various agreements that control the Foundations' governance and the disposition of the Shares include, *inter alia*: (1) the Transfer, Grant and Loan Agreement (the "TGLA") (corresponding to the document denominated in the Original Form A filing as the Stock Restrictions Agreement), (2) the Voting Trust and Divestiture Agreement (the "VTDA"), (3) the Registration Rights Agreement (the "RRA"—the TGLA, VTDA, and RRA being referred to collectively as the "Stock Governance Agreements"), (4) the Unallocated Shares Escrow Agreement, and (5) the Excess Share Escrow Agreement.[27]

D. Summary of the Holding Company Acts

In a proposed change of control under Washington law, an analysis is required of the following: (1) WASH. REV. CODE ANN. §§ 48.31B.005–.902 (the Insurer Holding Company Act - the "IHCA"), and (2) WASH. REV. CODE ANN. §§ 48.31C.010–.910 (the Holding Company Act for Health Care Service Contractors and Health Maintenance Organizations—"HHCA"). (The IHCA and the HHCA are collectively referred to throughout this Supplemental Report as the "Holding Company Acts.") The IHCA applies to domestic insurer acquisitions, and the HHCA applies to acquisitions of both domestic health care service contractors and health maintenance organizations (these contractors and organizations are referred to collectively by the HHCA as "domestic health carriers"). Both the IHCA and the HHCA apply to the Amended Transaction because PREMERA's subsidiaries include both domestic health carriers and insurers. In addition to the Holding Company Acts themselves, PREMERA is also governed by corresponding applicable regulations.[28] The

[27] In the Amended Transaction, PREMERA has eliminated the Indemnification Agreement and the Stockholder Protection Rights Agreement, which were both part of the Original Transaction's Stock Governance Agreements, about which the OIC's consultants had expressed serious reservations.

[28] *See, e.g.*, WASH. REV. CODE ANN. § 48.31B.015(2) (specifying information required to be filed with the Commissioner in the event of a merger or acquisition with a domestic insurer); WASH. REV. CODE ANN. § 48.31C.030(2) (specifying information required to be filed with the Commissioner in the event of a merger or acquisition with a domestic health carrier); WASH. ADMIN. CODE § 284-18-910 (2003) (providing the Form A to be used to satisfy the filing requirements in event of a merger or acquisition with a domestic insurer); WASH. ADMIN. CODE § 284-18A-910 (providing the Form A to be used to satisfy the filing requirements in the event of a merger or acquisition with a domestic health carrier).

requirements are substantially the same under the two Holding Company Acts and their corresponding regulations, so they are analyzed together, with notation of any material differences.[29]

In sum, the Commissioner is required to approve the Transaction unless he makes one or more of the following fact-findings: (1) after the change of control, the domestic health carrier would not be able to satisfy a domestic health carrier's registration requirements, (2) there is substantial evidence that the acquisition would substantially lessen competition or tend to create a monopoly in insurance in Washington, (3) the acquiring party's financial condition is such as might jeopardize the health carrier's financial stability or prejudice its subscribers' interests, (4) the plans or proposals that the acquiring party has to liquidate the specific health carrier, sell its assets, consolidate or merge it with any person, or to make any other material change in its business or corporate structure or management are unfair and unreasonable to the health carrier's subscribers, and not in the public interest, (5) the competence, experience, and integrity of those persons who would control the health carrier's operations are such that it would not be in the interest of the health carrier's subscribers and of the public to permit the acquisition of control, or (6) the acquisition is likely to be hazardous or prejudicial to the insurance-buying public.[30] Even if the Commissioner finds the existence of one or more of the foregoing bases for disapproval, with the exception of the first basis, he <u>may</u> condition approval on the removal of the basis for disapproval.[31]

E. Commissioner's Standard of Review

The burden of determining whether a change of control meets the legal requirements of the Holding Company Acts rests upon the Commissioner. That is, the Commissioner must approve the Transaction <u>unless</u> he makes a fact-finding that one or more of the Holding Company Acts' six adverse criteria exist(s) with respect to the Transaction. If he does make a fact-finding to the contrary, he may condition approval on the removal of the basis for disapproval. PREMERA is not required to put forth evidence establishing that the Holding Company Acts' six criteria for disapproving a Transaction do not exist. However, if the Commissioner makes a determination that sufficient evidence exists to disapprove the Transaction, based on at least one of the six criteria, then, as a practical matter, PREMERA must rebut the Commissioner's finding.[32]

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[29] Generally, the HHCA's statutory language, such as referring to health carriers rather than insurers, will be used in this Supplemental Report unless otherwise noted.

[30] *See* WASH. REV. CODE ANN. §§ 48.31C.030(5)(a)(i), (5)(a)(ii), (5)(a)(ii)(C)(I)–(IV) (enumerating the six potential disqualifying findings with respect to a domestic health carrier under the HHCA); *see also* WASH. REV. CODE ANN. §§ 48.31B.015(4)(a)(i)–(vi) (enumerating the same with respect to a domestic insurer under the IHCA).

[31] *See* WASH. REV. CODE ANN. § 48.31C.030(5)(a)(ii)(C) (the authority to grant a conditional approval seems to apply only to the last four criteria of the HHCA); *see also* WASH. REV. CODE ANN. § 48.31B.015(4)(a)(ii)(C) (the authority to grant a conditional approval seems to apply only to the second criteria of the IHCA).

[32] *See Blue Cross & Blue Shield of Kan., Inc. v. Praeger*, 75 P.3d 226, 252–53 (Kan. 2003) (stating that the Commissioner did not improperly shift the burden of proof to the applicant by merely weighing the evidence and finding that the evidence provided by the insurance department's consultant was more weighty and persuasive than that of the applicant).

The Washington legislature has codified the standard by which the judiciary may review an agency order. A court may overturn the agency's decision only if it determines one of the following:

(a) The order, or the statute or rule on which the order is based, is in violation of constitutional provisions on its face or as applied;

(b) The order is outside the statutory authority or jurisdiction of the agency conferred by any provision of law;

(c) The agency has engaged in unlawful procedure or decision-making process, or has failed to follow a prescribed procedure;

(d) The agency has erroneously interpreted or applied the law;

(e) The order is not supported by evidence that is substantial when viewed in light of the whole record before the court, which includes the agency record for judicial review, supplemented by any additional evidence received by the court under this chapter;

(f) The agency has not decided all issues requiring resolution by the agency;

(g) A motion for disqualification under WASH. REV. CODE ANN. § 34.05.425 or 34.12.050 was made and was improperly denied or, if no motion was made, facts are shown to support the grant of such a motion that were not known and were not reasonably discoverable by the challenging party at the appropriate time for making such a motion;

(h) The order is inconsistent with a rule of the agency unless the agency explains the inconsistency by stating facts and reasons to demonstrate a rational basis for inconsistency; or

(i) The order is arbitrary or capricious.[33]

F. Scope of the Consultants' Review

To assist in the evaluation of the Amended Transaction, the OIC has retained C&B to provide legal services, PricewaterhouseCoopers LLP ("PwC") to provide actuarial, accounting, tax, executive compensation and economic impact services, and The Blackstone Group L.P. ("Blackstone") to provide valuation and other financial related services. In addition to the consultants retained by the OIC, the Washington Office of the Attorney General (the "Attorney General") has retained the services of Dr. Keith Leffler, Ph.D. to provide supplemental input on antitrust issues (C&B, PwC, Blackstone, and Dr. Leffler are referred to collectively as the "Washington Consultants"). The Washington Consultants have been retained to supplement the

[33] WASH. REV. CODE ANN. § 34.05.570(3).

analysis submitted by each consultant on October 27, 2003. On February 27, 2004, PwC submitted supplemental reports reflecting its analysis of issues regarding accounting, tax, executive compensation and economic impact. PwC's analysis of executive compensation and economic impact issues are referred to herein as the "Supplemental Executive Compensation Report" and the "Supplemental Economic Impact Report," respectively. Blackstone also submitted a supplemental report on February 27, 2004, reflecting its analysis of valuation issues, which is referred to herein as the "Supplemental Valuation Report." Dr. Leffler submitted a supplemental report on antitrust issues.

In addition, a simultaneous proceeding in Alaska has been ongoing, and the Alaska Division of Insurance ("ADI") has retained the services of consultants to provide services that are similar to those provided by the Washington Consultants to the OIC. The consultants of Washington and Alaska are referred to collectively as the "Consultants," and the OIC and ADI are referred to collectively as the "Regulators." The Consultants and Regulators have worked closely with each other in order to maximize the efficiency and effectiveness of the review of the Amended Transaction. Although the Washington Consultants and the Alaska Consultants have coordinated their review where possible, their conclusions may differ because each group has conducted its own independent analysis for each state.

III. STAGE ONE

A. Change of Control: Filing Requirements

1. Completeness of the Form A

In a proposed change of control, the acquirer must file a Form A with the OIC.[34] The Holding Company Acts promulgate certain requirements that must be satisfied before the Form A can be deemed complete. PREMERA filed a Form A on September 17, 2002, and then amended it on October 25, 2002, and February 5, 2004. On September 5, 2003, The Honorable Paula Casey, of the Superior Court of Washington, in and for the County of Thurston, issued an opinion regarding when a Form A filing is considered complete under the Holding Company Acts.[35] Without opining on whether the Amended Form A is complete for purposes of the Holding Company Acts, aside from those items identified as privileged by Judge Finkle, the Consultants appear to have received substantially all the information required to evaluate the Transaction. The items that were outstanding as of the issuance of C&B's Final Report, have since been received with a sufficient time for review including the following: (1) the stock ownership plan ("SOP") that New PREMERA intends to adopt, and (2) the schedule of assets and liabilities it intends to transfer to PBC-AK.

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[34] WASH. REV. CODE ANN. § 48.31B.015(2), WASH. REV. CODE ANN. § 48.31C.030(2); *see also* WASH. ADMIN. CODE §§ 284-18-910 and 284-18A-910 (providing formats for the statutorily required information in a form known as the Form A).

[35] The OIC may not necessarily agree with Judge Casey's interpretation.

2. Identity of the Acquiring Party/Disclaimer of Control

The Amended Transaction envisions the conveyance of all of PREMERA's stock to the Foundations. Typically, that would make the Foundations the acquiring parties. However, PREMERA has gone to great lengths to assure that the Foundations, despite holding most of PREMERA's stock, will not be able to exercise control over PREMERA's operations. For example, the Foundations' voting rights are severely restricted under the VTDA and other documents. Although C&B does not agree with PREMERA's apparent interpretation of the disclaimer provisions, as discussed more fully in the Final Report, C&B does agree, for public policy reasons, that the Foundations should not be treated as the acquiring party.

B. Economic Viability of the Transaction

C&B has been engaged to address the economic viability of the Amended Transaction from a legal perspective. In general, for purposes of this analysis, economic viability can be viewed as adequacy of consideration. In the typical Form A proceeding, the OIC is not charged with ascertaining whether or not the parties struck a "good deal" or whether the sale price is reasonable. Those types of matters are generally left to the parties themselves. However, in the case of PREMERA's Amended Transaction, the "seller" effectively is the public, which has not been provided a seat at the negotiating table or a voice in setting the sale price. Thus, economic viability, in this instance, is the very material determination of whether the public's interest in PREMERA is safeguarded in the Amended Transaction. Put another way, the determination of economic viability inquires into whether the Washington Foundation will receive consideration substantially equivalent to its share of PREMERA's fair market value, as discussed *infra* at section IV.C.[36] The Commissioner's authority to determine the economic viability of the Amended Transaction in this sense is derived primarily from the Holding Company Acts. Under the Holding Company Acts, the Commissioner may disapprove a transaction if:

> [t]he plans or proposals that the acquiring party has to liquidate the health carrier, sell its assets, consolidate or merge it with any person, or to make any other material change in its business or corporate structure or management, are unfair and unreasonable to subscribers of the health carrier and *not in the public interest.*[37]

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[36] Because PREMERA faces charitable trust obligations both in Washington and Alaska, the measure of that obligation in each state is a share of the company's fair market value. The magnitude of each state's share (which will be manifested as a percentage of New PREMERA's outstanding stock before the IPO) is the subject of separate proceedings and not addressed in C&B's analysis. For purposes of this discussion, the obligation in Washington is to deliver to the Washington Foundation the equivalent of Washington's share (whatever that may turn out to be) of PREMERA's fair market value. References in C&B's analysis to the requirement that PREMERA's fair market value be delivered to the citizens of the State of Washington, or to the Washington Foundation, should be understood to mean Washington's share of that value.

[37] WASH. REV. CODE ANN. § 48.31C.030(5)(a)(ii)(C)(II) (emphasis added); *see also* WASH. REV. CODE ANN. § 48.31B.015(4)(a)(iv) (providing almost exactly the same definition under the IHCA).

Although it is not part of the Transaction *per se*, the IPO is an integral component of the Transaction, because it is the mechanism by which PREMERA has chosen to achieve the Transaction's ultimate purpose, which is to raise capital. Moreover, it is the IPO which first will deliver consideration to the Washington Foundation. As the Amended Transaction is structured, the Washington Foundation will receive stock, the proceeds of the sale of which the foundation will convey to tax-exempt organizations.[38] Not before such sales occur can the Washington Foundation receive any consideration. The first such sale will be the IPO. Subsequent sales of stock (mandatory or optional) will result in delivery of additional consideration to the Washington Foundation. The terms and timing of these sales, therefore, are essential determinants of whether the public (through the office of the Washington Foundation) will receive the equivalent of its share of PREMERA's fair market value in consideration for the conversion. These are the issues that will therefore determine whether the Amended Transaction is economically viable.

As of the Final Report, Blackstone noted that there are currently several potential problems[39] with an IPO, including possible negative investor reaction to the potential loss of the Internal Revenue Code ("I.R.C.") § 833(b) deduction, and "overhangs" by the Foundations depressing the price of the Shares due to the compelled divestiture. Moreover, since the issuance of the Final Report, PREMERA decided that it may not provide a tax opinion indicating that it is "more likely than not" that PREMERA will retain the I.R.C. § 833(b) deduction. In any event, these problems may be absorbed by the market while still allowing for a successful IPO, and other problems may be mitigated to some degree. Other problems relate to the transfer of fair market value to the Washington Foundation or to the Transaction's potential negative effects on PREMERA and will be discussed in greater detail later in this Supplemental Report.

1. IPO Procedures Opinion

Economic viability is probably best defined *initially* as whether, under the circumstances contemplated in the Amended Transaction, a successful IPO is likely to occur for PREMERA, and whether the IPO can indeed succeed, given market conditions at the time of the IPO. In section 5.3(b) of the Plan of Conversion, PREMERA has provided for the monitoring of the foregoing by allowing financial advisors, acting on the Commissioner's behalf, to be given access to the information and pricing of the Shares in the IPO, and eventually to issue an opinion encompassing, *inter alia*, the economic viability of the Transaction (the "IPO Procedures Opinion"). The attorneys for the State of Washington will also have an opportunity to review, and comment, on the information provided to the financial advisors acting on the Commissioner's behalf. The IPO Procedures Opinion serves two purposes. The first is to inform the Commissioner on the analysis of the foregoing issues near the time of the IPO. The second purpose is to provide the Washington Foundation with the information required for its Board of Directors to make well-informed decisions regarding how many of the Shares to sell, and at what price.

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[38] The documents in the Amended Form A conflict as to whether the Washington Foundation is to distribute proceeds to any tax-exempt organization or to I.R.C. § 501(c)(3) organizations only.

[39] Because the analysis of economic viability cannot occur until the date of the IPO nears, the Consultants cannot determine whether these problems will cause the Transaction to fail this requirement.

With respect to the first purpose, the IPO Procedures Opinion may not be reliable. In order for the IPO Procedures Opinion to be of greater reliability, Blackstone believes that at least four (4) weeks prior to the start of the IPO "road show," PREMERA should make a preliminary proposal regarding the parameters of the contemplated IPO (size, split between primary and secondary shares, and pricing range) to the OIC and its advisors. PREMERA has not provided for such a presentation. With respect to the second purpose, PREMERA has not provided the Washington Foundation with the ability to access, and rely, on the information analyzed in the IPO Procedures Opinion. This lack of access affects the Washington Foundation's ability to determine what portion of its Shares should be included in the IPO in order to ensure that fair market value is conveyed and to prevent the dilution of the Shares, as indicated by Blackstone in its Supplemental Valuation Report and discussed more fully in C&B's Final Report. In addition to the potential dilution of PREMERA's value, shares sold at the time of an IPO are, typically, discounted in order to facilitate a successful offering as discussed more fully in C&B's Final Report. If the Washington Foundation does not have the ability to access, and rely upon, the information analyzed in the IPO Procedures Opinion, then, alternatively, the Washington Foundation must have the ability to appoint a joint book running manager in order to protect its interests.

2. Bring Down Opinion

Another issue raised in the Final Report was the need to have the IPO occur within a reasonable time following the Commissioner's approval, in order to avoid a scenario in which the Commissioner approves the Transaction, but before the IPO closes, material changes occur in matters on which the Commissioner relied. Moreover, although the Washington Foundation will have received the Shares under this scenario, the Shares would be illiquid because no public market would exist in which to sell the Shares. During the time that the Washington Foundation is essentially handicapped from realizing the value of the Shares, PREMERA would have become for-profit without any charitable obligation to the Washington public. The potential, thus, exists that the Washington Foundation may not receive funds which can be used to support health initiatives in the State of Washington. In order to resolve this potential problem, PREMERA has indicated in section 4.3(b) of the Plan of Conversion that the closing of the Amended Transaction shall occur once all the conditions in section 4.3(a) have been fulfilled. PREMERA has not defined the term "closing," but in section 5.3(a) of the Plan of Conversion, PREMERA states that the IPO shall occur on the date of the closing. Presumably, the IPO must occur for PREMERA to close the Transaction. If PREMERA did not intend section 4.3(b) to include the IPO, then the Transaction does not satisfy the Consultants' concern.

Even if the "closing" did include the IPO, it is impracticable to have the IPO close on the same date as the Commissioner's order. In order to market a successful IPO, and to satisfy all federal regulatory rules in conducting an IPO, PREMERA will require six to nine months of time after it receives the Commissioner's approval of the Transaction. PREMERA, thus, requires some flexibility in order to conduct its IPO at the optimal time, which may enhance PREMERA's ability to transfer fair market value. The longer the lapse of time between the receipt of all regulatory approvals, and the IPO, the greater the likelihood of intervening material changes. PREMERA has provided itself 12 months after the receipt of all regulatory approvals to complete the IPO (the "Initial Time Period"). Despite being longer than the six to nine months required to conduct an IPO, the Initial Time Period may not be inherently unreasonable given the practical time constraints of conducting an IPO. PREMERA, however, has provided for two automatic three-month extensions (the "Automatic Extensions") after the Initial Time Period has expired if litigation related to the Transaction is pending. As a general matter, such Automatic Extensions greatly increase the probability of material changes between the Commissioner's approval and the IPO. Such changes could make the Commissioner's approval no longer applicable. If additional time is needed, PREMERA should be required to make a formal request to the Commissioner for an extension, with the Commissioner having sole discretion in determining whether an extension is warranted, based on the circumstances at that time. The Commissioner would also require the ability to evaluate intervening material changes, or to receive reasonable assurances that none have occurred. Indeed, the Commissioner may determine that, after the Initial Time Period's expiration, PREMERA should be required to file a new Form A due to intervening changes. Providing for Automatic Extensions in the Plan of Conversion is therefore contrary to the spirit of the statutes and the public interest.

The triggering event for the Initial Time Period is also worth some discussion. The Initial Time Period does not begin until all regulatory approvals have been received, which will occur necessarily after the Commissioner's ruling, because the Alaska proceeding will not have been completed by that time. The trigger date for the Initial Time Period also includes the date upon which the BCBSA confirms that the Mark will not be terminated. As discussed, *infra* at section IV.C.3, the BCBSA is not a government agency with regulatory authority, or a party to this proceeding, and thus, any requirement for the BCBSA's approval in order to trigger the Initial Time Period is inappropriate. PREMERA should be required to resolve such contingencies as the effect of the conversion on its BCBSA license <u>before</u> seeking and obtaining the Commissioner's approval. Requiring the Commissioner to grant a "pocket approval" to be utilized by PREMERA only if other conditions are later met, is an abuse of the regulatory process undermining the legislative intent that the Commissioner approve a specific transaction. It would amount to giving PREMERA *carte blanche* to implement any of a variety of transactions, depending on material developments that the Commissioner will not have been able to factor in his determination. Such potential material changes may affect substantially many issues within the scope of the applicable approval standards, including whether fair market value has been conveyed. Material changes in any area upon which the Commissioner may have based his decision in granting his approval of the Transaction may be implicated, including whether the Amended Transaction is contrary to the public interest, or whether it is contrary to the interests of policyholders, under the Holding Company Acts. The flexibility required for PREMERA to conduct a successful IPO, therefore, should be balanced against the overriding legal requirement that the specific proposed transaction have been evaluated and approved by the Commissioner.

In order to mitigate the risk that the Commissioner would not have granted the approval near the time of the IPO, PREMERA has provided in section 4.3(b)(ii) of the Plan of Conversion that the Consultants will issue "bring down" opinions (the "Bring Down Opinions") shortly prior to the IPO. These Bring Down Opinions would inform the Commissioner as to the effect and importance of developments in areas considered by the Commissioner in issuing his ruling. These opinions would be based on a substantially less intensive review of the Amended Transaction than the current review process, but provide an additional safeguard to the extent that the information provided by PREMERA is of adequate scope for the Consultants to update their opinions. Section 4.3(b)(ii) is structured in a manner that requires PREMERA to certify whether any change has occurred in certain areas of the Consultants' review, and if so, PREMERA will specify the nature of the change (the "Reportable Change"). Section 4.3(b)(ii) falls well short of the information that the Consultants require to complete their Bring Down Opinions for a number of reasons. PREMERA indicates that a Reportable Change will be deemed to have occurred only if the "form" of the documents submitted as part of the Amended Form A has changed. It is unclear what PREMERA means by a change in the "form" of the documents. While the documents themselves are in many cases important, often the underlying facts are even more important. Thus, Reportable Change must also include any material change in the facts and circumstances upon which the Consultants' relied in their review and the Commissioner relied in his decision.

Recognizing the importance of this principle, and at the Consultants' insistence, PREMERA has specified some such areas of "Reportable Change," but more narrowly than is appropriate under the circumstances. For example, PREMERA indicates that a decrease in enrollment of more than 10% by line of business in the combined operations of PREMERA in the states of Alaska and Washington would constitute a Reportable Change. However, this may not be sufficiently specific. In its Supplemental Economic Impact Report, PwC indicates that this proposed measure is too broad to protect consumers adequately. PwC notes that section 5.3(b) fails to compel PREMERA to identify "material changes in enrollment by defined geographic regions, and in particular . . . on changes in enrollment separately for the areas of eastern Washington identified as at-risk in [its] October 2003 report." Similarly, PREMERA suggests that a Reportable Change will be deemed to have occurred if there is any change in "PBC's prior affiliated ratings." The Consultants are unclear as to the meaning of that phrase. If PREMERA means that a Reportable Change will be deemed to have occurred if there has been <u>any</u> change in the ratings of PBC and its affiliates, then PREMERA's formulation may suffice. PREMERA also indicates that a change of more than 50 percentage points in PBC's risk-based capital ("RBC") ratio would constitute a Reportable Change. In the Supplemental Valuation Report, Blackstone indicates that this threshold is inadequate, for example, because one of the primary reasons for PREMERA's conversion is its assertion that PBC's RBC is too low. An increase of between 25 and 49 percentage points in RBC may alter the Consultants' perception of PREMERA's need to convert. Furthermore, a decline of between 25 and 49 percentage points in RBC may impair the economic viability of the IPO. Thus a threshold of half the proposed magnitude of change in RBC would be far more appropriate. Additionally, PREMERA suggests that a Reportable Change be deemed to have occurred if there has been a material change in the recommendations of PREMERA's investment banking and financial consultants, or if there have been any new recommendations made by such consultants that contradict their previous recommendations. PREMERA has relied on numerous advisors, such as executive compensation consultants, not all of whom are investment banking or financial consultants. In turn, the OIC's Consultants have relied, in part, on the opinions of PREMERA's consultants. Thus, the scope of this Reportable Change should be broadened to include any consultant, not just investment banking and financial consultants. In sum, the foregoing limitations on the Reportable Changes may impair the Consultants' ability to provide reliable Bring Down Opinions, and therefore, the value of such opinions to the Commissioner in assessing the risk that a material change has occurred following his decision.

C. Washington Insurance Code, Washington Administrative Code, Washington Nonprofit Corporation Act, and Federal Law

C&B's Analysis is based on the information made available as of the February 5, 2004, amendment deadline. Unless specifically noted, this analysis assumes that the Form A is complete for purposes of evaluating the substantive statutory requirements. The possibility exists that information produced after the completion of C&B's Analysis, or information that was not required to be produced by Judge Finkle on grounds of privilege, would have compelled different conclusions, thereby limiting the usefulness of C&B's Analysis.

1. Washington Insurance Code

a. Holding Company Acts: Substantive Requirements

The substantive requirements applicable to PREMERA's change of control are furnished primarily by the Holding Company Acts. The intricacies of the Holding Company Acts are described more fully in C&B's Final Report. Under the Holding Company Acts, generally, the Commissioner must approve the acquisition of control unless, after a public hearing, he finds either that: (1) after the change of control, the domestic health carrier would not be able to satisfy a domestic health carrier's registration requirements, (2) there is substantial evidence that the acquisition would substantially lessen competition or tend to create a monopoly in insurance in Washington (the "Antitrust Inquiry"),[40] (3) the acquiring party's financial condition is such as might jeopardize the health carrier's financial stability or prejudice its subscribers' interest, (4) the plans or proposals that the acquiring party has to liquidate the health carrier, sell its assets, consolidate or merge it with any person, or to make any other material change in its business or corporate structure or management are unfair and unreasonable to the health carrier's subscribers, and not in the public interest, (5) the competence, experience, and integrity of those persons who would control the health carrier's operations are such that it would not be in the interest of the health carrier's subscribers, and of the public, to permit the acquisition of control, or (6) the acquisition is likely to be hazardous or prejudicial to the insurance-buying public.[41] Even if the Commissioner finds the existence of one or more of the foregoing bases for disapproval, with the exception of the first basis, he <u>may</u> condition approval on the removal of the basis for disapproval.[42]

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[40] WASH. REV. CODE ANN. § 48.31C.030(5)(a); *see also* WASH. REV. CODE ANN. § 48.31B.015(4)(a) (requiring under the IHCA only an "effect . . . to substantially lessen competition," and not the "substantial evidence" standard of the HHCA).

[41] *See* WASH. REV. CODE ANN. § 48.31C.030(5)(a)(i), (5)(a)(ii), (5)(a)(ii)(C)(I)–(IV) (enumerating the six potential disqualifying findings with respect to a domestic health carrier under the HHCA); *see also* WASH. REV. CODE ANN. §§ 48.31B.015(4)(a)(i)–(vi) (enumerating the same with respect to a domestic insurer under the IHCA).

[42] *See* WASH. REV. CODE ANN. § 48.31C.030(5)(a)(ii)(C) (the authority to grant a conditional approval seems to apply only to the last four criteria of the Holding Company Acts); *see also* WASH. REV. CODE ANN. § 48.31B.015(4)(a)(ii)(C) (the authority to grant a conditional approval seems to apply only to the second criteria of the Holding Company Acts).

The following two subsections of this Supplemental Report discuss the Holding Company Acts' first two potential bases for disapproval, and the next four potential bases for disapproval are discussed *infra* at section III.D. Those four factors are analyzed separately because they involve the Transaction's fairness to policyholders, providers, and the public, which was a separate and distinct assignment under Stage One of the Original Engagement.

(1) Licensing and Registration Requirements

Under the first standard, the Commissioner is required to disapprove the Transaction if he finds that New PBC or New LifeWise of Washington cannot meet the requirements to register as health care service contractors,[43] or LifeWise Assurance or LifeWise of Arizona would no longer be able to satisfy the licensing requirements to write the line or lines of insurance for which they are presently licensed.[44] The analysis and conclusions in this section are discussed more fully in C&B's Final Report. There is no reason to conclude that the foregoing registration or licensing requirements cannot be met. Moreover, although LifeWise Assurance and LifeWise of Arizona are not converting, they must continue to satisfy the requirements for a certificate of authority. There is no reason to conclude that the Transaction will affect their certificates of authority adversely.

In addition, the Commissioner may refuse to accept the registration of a health care service contractor, or revoke an insurer's certificate of authority if he finds that the company's financial condition jeopardizes the payment of claims and refunds to subscribers or is hazardous to policyholders.[45] These determinations are substantially similar to, and addressed more appropriately under, the sixth criterion of the Holding Company Acts, which is discussed *infra* at section III.D.4.

(2) Antitrust Inquiry

In addressing the second potential basis for disapproval, the Commissioner will review the Transaction's effects on competition. In addition, the Attorney General will provide input to the Commissioner because the Attorney General has decided not to undertake a review of the Transaction. The analysis and conclusions in this section are discussed more fully in C&B's Final Report. Arguably, the conversion does not raise any antitrust concerns under the IHCA because the Transaction is between already affiliated persons, and apparently, there will be no *immediate* increase in any market share as a result of the Transaction. Moreover, C&B believes that the causal link between the additional capital from the IPO and possible anticompetitive events is too speculative to result in a finding that the Transaction fails the Antitrust Inquiry.

A question somewhat related to the anticompetitive effect is whether New PREMERA's status as a for-profit company will likely result in a disparity in bargaining power between health care providers and New PREMERA because of New PREMERA's access to additional capital and

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[43] *See* WASH. REV. CODE ANN. § 48.31C.030(5)(a)(i).

[44] *See* WASH. REV. CODE ANN. § 48.31B.015(4)(a)(1).

[45] WASH. REV. CODE ANN. § 48.44.160(2); WASH. REV. CODE ANN. § 48.05.140(2).

resulting potential for rapid growth. Another issue related to the Antitrust Inquiry is whether PREMERA's market power will allow it to raise premium rates or to reduce provider compensation in response to shareholder pressures. These possibilities are more likely to involve the extent to which the plans for New PREMERA are contrary to the interests of policyholders or the public, as discussed *infra* at section III.D.2. Nonetheless, the Attorney General's office may undertake an analysis that also encompasses some of the foregoing issues as part of the input that it will provide to the Commissioner.

b. Notice of Material Transactions

The Commissioner must receive prior notice of certain transactions between affiliates within either an insurance holding company system or a health carrier holding company system. For these transactions, prior notice to the Commissioner, through a Form D filing, is required.[46] New PREMERA's Form D is an exhibit to its Form A. Such transactions include, *inter alia*, the following: (1) management agreements, service contracts, and cost-sharing arrangements,[47] (2) other acquisitions or dispositions of assets involving more than 5% of the health carrier's admitted assets, specified by rule, that the Commissioner determines may adversely affect the interests of the health carrier's subscribers,[48] or (3) material transactions, specified by rule, that the Commissioner determines may adversely affect the interests of the insurer's policyholders.[49]

Moreover, these transactions are subject to the following standards: (1) the terms must be fair and reasonable, (2) charges or fees for services performed must be fair and reasonable, (3) expenses incurred and payment received must be allocated to the health carrier or insurer in conformity with customary statutory accounting practices consistently applied, (4) each party's books, accounts, and records must be so maintained as to clearly and accurately disclose the transaction's nature and details, including accounting information necessary to support the reasonableness of charges and fees to the respective parties,[50] and (5)(a) the health carrier's net worth after the transaction must exceed the health carrier's company action-level risk-based capital,[51] or (5)(b) the insurer's surplus regarding policyholders, after dividends or distributions to shareholders or affiliates, must be reasonable in relation to the insurer's outstanding liabilities and

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[46] WASH. REV. CODE ANN. § 48.31C.050(2); WASH. ADMIN. CODE §§ 284-18A-420, 18A-940. For the IHCA's provisions, *see* WASH. REV. CODE ANN. § 48.31B.030(1)(b); WASH. ADMIN. CODE §§ 284-18-440, 18-940.

[47] WASH. REV. CODE ANN. § 48.31C.050(2)(d); WASH. REV. CODE ANN. § 48.31B.030(1)(b)(iv).

[48] WASH. REV. CODE ANN. § 48.31C.050(2)(e). A similar provision is not found in the IHCA.

[49] WASH. REV. CODE ANN. § 48.31B.030(1)(b)(v). A similar provision is not found in the HHCA.

[50] WASH. REV. CODE ANN. §§ 48.31C.050(1)(a)–(d) (listing these four HHCA provisions); WASH. REV. CODE ANN. §§ 48.31B.030(1)(a)(i)–(iv) (listing these four IHCA provisions).

[51] WASH. REV. CODE ANN. § 48.31C.050(1)(e).

adequate to its financial needs.[52] These last two factors ((5)(a) and (5)(b)) are inapplicable, because PREMERA's surplus is expected to increase as a result of the Transaction.[53]

New PREMERA's Form D meets all the informational requirements under the WASH. ADMIN. CODE. The agreements in the Amended Transaction that are required to be disclosed in the Form D are the Management Agreement, Intercompany Services and Cost Allocation Agreement (the "Cost Agreement"), the Intercompany Tax Sharing Agreement (the "Tax Agreement"), the guaranty agreement between New PREMERA and New PBC (the "New PBC Guaranty") and the guaranty agreement between New PREMERA and PBC-AK (the "PBC-AK Guaranty") (the two guaranty agreements are referred to collectively as the "Guaranty Agreements"). All of the foregoing agreements except for the Guaranty Agreements were part of the Original Transaction.

Pursuant to the Management Agreement, New PBC will provide management and administrative services to PBC-AK "in order for PBC-AK to carry out its business and operations in [a] manner substantially consistent with the manner in which PBC carried out its business and operation . . . prior to" the Transaction as described more fully in C&B's Final Report. PREMERA has not changed substantively the Management Agreement since the issuance of C&B's Final Report with the exception of sections regarding indemnification and liability. As currently stated, PBC-AK agrees that: (1) New PBC will not be liable in tort or in contract unless New PBC breaches the agreement, commits gross negligence, or commits willful misconduct, (2) PBC-AK will indemnify New PBC for liability, except for negligence or willful misconduct, arising from the management services, and (3) New PBC will not be liable for any consequential or punitive damages. At the time of C&B's Final Report, PBC-AK would not have held New PBC liable for New PBC's breach of the Management Agreement, and PBC-AK would have indemnified New PBC in cases of negligence as opposed to only gross negligence as currently stated.

The Cost Agreement provides for the payment for services on a cost basis between New PREMERA and its related affiliates as described more fully in C&B's Final Report. In addition, the Cost Agreement describes cost allocation methods and procedures for the allocation of general and administrative ("G&A") expenses. PREMERA has not changed the Cost Agreement substantively since the issuance of C&B's Final Report.

The Tax Agreement provides that New PREMERA and its affiliates will file a consolidated return, and New PREMERA will pay all taxes as described more fully in C&B's Final Report. PREMERA has not changed the Tax Agreement substantively since the issuance of C&B's Final Report with the exception of the modification to language regarding reimbursement for the use of components of taxable income. This modified language has the positive effect of reaffirming that members will be reimbursed for certain tax attributes that would have been generated on a separate return basis.

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[52] WASH. REV. CODE ANN. § 48.31B.030(1)(a)(v).

[53] WASH. REV. CODE ANN. § 48.31C.050(1)(e) (stating, for the HHCA, that this provision "does not prohibit transactions that improve or help maintain the health carrier's net worth"). Although WASH. REV. CODE ANN. § 48.31B.030(1)(a)(v) does not have a similar exclusion, as a practical matter, this section would be inapplicable.

As most recently amended, the Amended Transaction now contemplates that New PREMERA will have two operating subsidiaries, New PBC and PBC-AK. For purposes of the BCBSA license, each of these subsidiaries will be a "controlled affiliate" of New PREMERA, the primary BCBSA licensee. At the request of the Consultants, PREMERA has included in the Amended Transaction the Guaranty Agreement, under which New PREMERA agrees "to guarantee the obligations of New PBC to its subscribers" and a corresponding agreement for PBC-AK. Ostensibly, both agreements provide "claims guarantees" for the operating subsidiaries, in accordance with BCBSA guidelines. But there are material differences between them. As the Consultants had expected, the agreement for PBC-AK also requires New PREMERA to guarantee the "expenses, liabilities and other obligations" that PBC transferred to PBC-AK, to the extent that PBC-AK is unable to pay them. Further, New PREMERA agrees to make the necessary capital contributions to prevent PBC-AK's risk based capital position from declining below 375%. These two additional provisions are attributable to the separation of what becomes PBC-AK from PBC, and are not problematic.

However, the claims guarantees provided to the two subsidiaries are materially different. The relevant provision in the Washington agreement defines the guarantee as that corresponding to "Standard 6(H)—Financial Responsibility" of the BCBSA Controlled Affiliate License Agreement. That standard requires that a "Controlled Affiliate shall be operated in a manner that provides reasonable financial assurance that it can fulfill all of its contractual obligations to its customers." The Alaska agreement refers to Standard 2—Financial Responsibility, which provides:

> A Controlled Affiliate shall be operated in a manner that provides reasonable financial assurance that it can fulfill all of its contractual obligations to its customers. If a risk-assuming Controlled Affiliate ceases operations for any reason, Blue Cross and/or Blue Cross Plan coverage will be offered to all Controlled Affiliate subscribers without exclusions, limitations or conditions based on health status. If a nonrisk-assuming Controlled Affiliate ceases operations for any reason, sponsoring Plan(s) will provide for services to its (their) customers.

The inclusion of the obligation to replace coverage (absent from the Washington guarantee) is no less appropriate for the guarantee issued as to PBC. The Commissioner should require that, in this respect, the guarantees mirror each other.

Additionally, the determination by the Commissioner of whether PREMERA's Form D complies with applicable law, turns, in part, on determinations within the scope of PwC's engagement, such as the financial reasonableness of the Cost Agreement, Tax Agreement, Management Agreement, and Guaranty Agreements. For the Management Agreement and Cost Agreement, the proposed charges for services to be performed must be fair and reasonable. PwC has indicated that the expenses incurred and payments received as part of the Management Agreement and Cost Agreement will be allocated according to customary statutory accounting practices consistently applied. Moreover, the Tax Agreement and Guaranty Agreements must not be financially unfair or unreasonable. PwC believes that the modifications in the Tax Agreement are necessary in order to make it financially fair and reasonable. From a legal perspective, the terms of these agreements do not otherwise appear to make them inherently unfair or unreasonable despite certain modifications made to the indemnification and liability provisions of the Management Agreement. There is, however, a material concern with respect to the Guaranty Agreements as discussed above. The other statutory requirements are inapplicable to the Transaction.

c. Transfer of Insurance Contracts

Another issue to be considered is whether the transfer of insurance contracts from PBC to New PBC and from LifeWise of Washington to New LifeWise of Washington is appropriate under applicable law. PREMERA requests that the Commissioner confirm that the transfer of all insurance contracts (as defined in WASH. ADMIN. CODE § 284-95-030(6)) will not be deemed to trigger the requirements of WASH. ADMIN. CODE Chapter 284–95 (which includes health care service contractors). When applicable, these regulations impose certain policy owner notification and consent requirements and proscribe discrimination and certain other practices.

The regulation governing the transfer of insurance contracts does not apply in specified circumstances, including mergers, when a transferring company withdraws from the state pursuant to WASH. REV. CODE ANN. § 48.05.290, or absorptions by parent companies.[54] The Amended Transaction should be deemed to be encompassed within one or more of these exemptions. For example, WASH. REV. CODE ANN. § 48.05.290 states, in pertinent part, that "[n]o insurer shall withdraw from this state until its direct liability to its policyholders and obligees under all its insurance contracts then in force in this state has been assumed by another authorized insurer under an agreement approved by the [C]ommissioner."

The Amended Transaction can be deemed to satisfy the requirements of WASH. REV. CODE ANN. § 48.05.290 because LifeWise of Washington will transfer its insurance contracts to another authorized insurer, New LifeWise of Washington, and LifeWise of Washington will withdraw from the state pursuant to its Articles of Dissolution. Thus, the Commissioner may approve the agreement that requires New LifeWise of Washington to assume LifeWise of Washington's insurance contracts. Similarly, PBC will transfer its insurance contracts to another authorized insurer, New PBC, and PBC will withdraw from the state pursuant to its Articles of Dissolution. Again, the Commissioner may approve the agreement that requires New PBC to assume PBC's insurance contracts.

It is critically important that the transfer not result in any adverse change in the terms or cost of coverage. In Article II of the Plan of Conversion, PREMERA assures that the Amended Transaction "will not, in any way, change health care benefits to subscribers." This assurance, however, relates to the terms of coverage only, and not to its cost. Assurances should also be provided that, as policies or contracts are transferred from one insurer (or health care service contractor) to another, the charges levied for the coverage also will not change. The only assurance with respect to changes in the cost of coverage is that provided indirectly with respect to PwC's analysis of the potential increase in premium rates due to PREMERA's change in corporate structure from a nonprofit company to a for-profit company as discussed *infra* at section III.D.2.c.(1). In order to mitigate PwC's concerns about potential increases in premium rates, PREMERA has

[54] WASH. ADMIN. CODE § 284-95-020(3) (2003).

provided certain assurances with respect to the method by which it will calculate those rates, as discussed in that section. The Commissioner should not approve the transfer of policies contemplated in the Amended Transaction unless he is satisfied that the assurances provided by PREMERA are sufficient to overcome the potential negative affect to subscribers. It should be noted that PwC believes that assurances regarding premium rates should be for a term of three years as opposed to the currently proposed term of two years. If the Commissioner determines that PREMERA has provided sufficient such assurances, and if all the other substantive requirements for the Transaction's approval are satisfied, then the Commissioner's approval of the assumption of insurance contracts is merely a formality.

d. Solicitation Permits

The Washington Insurance Code also imposes upon the Transaction certain requirements related to the solicitation of capital. As discussed in the Final Report, at the time solicitation of capital occurs (presumably after the S-1 registration statement required by federal securities laws has been completed), New PREMERA will be required to provide such plans in order for the Commissioner to determine whether New PREMERA complies with this requirement of the Washington Insurance Code. Since the solicitation permit documents will be submitted at a later stage of the conversion, C&B cannot now express any views as to the Amended Transaction's compliance with these provisions. Suffice it at this juncture, therefore, to note that the application for such solicitation permit, and the underlying plans, should be evaluated by the OIC before commencement of the solicitation for capital.

2. Washington Nonprofit Corporation Act

Generally, compliance with the Washington Nonprofit Corporation Act is a matter within the Attorney General's authority as *parens patriae*. With respect to its role regarding the transfer of charitable assets, WASH. REV. CODE ANN. § 24.03.230 provides that "If the plan of distribution includes assets received and held by the corporation subject to limitations described in subsection (3) of RCW 24.03.225, notice of the adoption of the proposed plan shall be submitted to the attorney general." The limitations of WASH. REV. CODE ANN. § 24.03.225(3) as referred to above are as follows:

> [a]ssets received and held by the corporation subject to limitations permitting their use only for charitable, religious, eleemosynary, benevolent, educational or similar purposes, but not held upon a condition requiring return, transfer or conveyance by reason of the dissolution, shall be transferred or conveyed to one or more domestic or foreign corporations, societies or organizations engaged in activities substantially similar to those of the dissolving corporation, pursuant to a plan of distribution adopted as provided in this chapter.[55]

Thus, the Attorney General must determine whether PREMERA's assets are being transferred to an entity that is engaged in activities substantially similar to those of PREMERA. Generally,

[55] WASH. REV. CODE ANN. § 24.03.225(3).

PREMERA is engaged in providing health-related activities to the residents of the State of Washington. More than the mere purposes of the entity to which PREMERA's assets are being transferred, the Attorney General must determine whether the mechanics by which those purposes will be effected are appropriate. These mechanics include whether appropriate corporate governance provisions are included in the organizational documents in order to enable the corporation to further its purposes. In part, this will include an analysis of the powers, qualifications, duties, and independence of the Board of Directors. Moreover, the Washington Nonprofit Corporation Act provides certain due diligence requirements, which must be evaluated by the Attorney General.

Additionally, the Holding Company Acts allow the Commissioner to disapprove the Transaction if he finds that the plans or proposals that the acquiring party has to liquidate the health carrier, sell its assets, consolidate or merge it with any person, or to make any other material change in its business or corporate structure or management, are unfair and unreasonable to the health carrier's subscribers, and not in the public interest as described *infra* at section III.D.2. The appropriateness of the Articles of Incorporation and Bylaws of the Washington Foundation, and the due diligence conducted by PREMERA's officers and directors, are integral parts of the foregoing requirement of the Holding Company Acts. The Commissioner must take into account whether the Washington Foundation has in place corporate governance provisions and purposes that will be contrary to the public interest similar to the analysis which will be conducted by the Attorney General.

a. Due Diligence

The applicable due diligence requirements compel a nonprofit corporation's directors and officers with discretionary authority to perform their duties: "(a) [i]n good faith; (b) [w]ith the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (c) [i]n a manner the director or officer reasonably believes to be in the best interests of the corporation."[56] This requirement is discussed more fully in C&B's Final Report. To determine whether the Transaction is unfair and unreasonable to subscribers or policyholders, and not in the public interest, the Commissioner must determine whether PREMERA's Board of Directors exercised due diligence in authorizing the conversion and the proposed terms and conditions thereof.[57] One such option is a potential merger with another insurer. It is, however, unnecessary for the current proceeding that the Commissioner be informed, or even speculate, about whether New PREMERA will ever propose to be acquired. Indeed, the Commissioner need not conclude that the Amended Transaction is the best option available in order to approve the application. Rather, the Commissioner must determine whether the Amended Transaction is in the interest of policyholders and the public. By itself, any weakness in PREMERA's due diligence may not compel rejection of the Amended Transaction. However, it is a significant additional factor the

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[56] WASH. REV. CODE ANN. § 24.06.153(1).

[57] *Cf.* WASH. REV. CODE ANN. § 70.45.070(2) (providing that an acquisition of a nonprofit hospital by a for-profit entity may not be approved unless the nonprofit corporation that owns the hospital being acquired "has exercised due diligence in authorizing the acquisition, selecting the acquiring person, and negotiating the terms and conditions of the acquisition").

Commissioner may consider in evaluating whether the Amended Transaction is in the interest of policyholders and the public.

b. Washington Foundation's Articles of Incorporation and Bylaws

PREMERA has eliminated the Charitable Organizations and has created a Washington Foundation and an Alaska Foundation, both of which are planned to be corporations exempt from federal income tax under § 501(c)(4) of the I.R.C. In restructuring the Transaction, PREMERA has included provisions that conflict with the Attorney General's duty to ensure that the assets are being transferred to a nonprofit organization with purposes and corporate governance provisions that will fulfill the charitable and social welfare purposes related to health initiatives in the State of Washington. Likewise, the Commissioner has a similar duty under the Holding Company Acts. In this section, the terms "Articles of Incorporation," "Bylaws" or "Board of Directors" will mean those of the Washington Foundation, unless otherwise specified.

(1) No Inurement to Private Persons

Section 3 of Article IV of the Articles of Incorporation provide that "No part of the net earnings of the [Washington Foundation] shall inure to the benefit of, or be distributable to, any officer, director, or other private person except that the [Washington Foundation] is authorized or empowered to pay reasonable compensation for services rendered. . . ." This provision seems to indicate that directors will be entitled to receive compensation for services rendered, but Section 3.11 of the Bylaws states that "the [Washington Foundation] shall not compensate directors for their services as directors." As a tax-exempt nonprofit organization with the primary purpose to support health initiatives in the State of Washington through the disbursement of funds to other tax-exempt organizations, there is not a strong reason to use such funds to compensate the Board of Directors. Qualified individuals with the requisite experience necessary to execute the Washington Foundation's purposes will do so because of their desire to further the public interest and not because of any compensation which they may receive. Moreover, such compensation will necessarily reduce the funds available to support health initiatives. If PREMERA intended to prohibit director compensation as set forth in the Bylaws, then there is not a concern with respect to these provisions.

(2) Lobbying

A substantial concern regarding the Original Transaction was the Foundation Shareholder's ability to lobby on PREMERA's behalf. That concern was driven by the lack of independence between the Foundation Shareholder and New PREMERA, and the further restriction that lobbying be limited to activities that essentially benefitted health insurers. In the Amended Transaction, however, the Washington Foundation is independent from New PREMERA, and thus, concerns that the Washington Foundation will engage in activities which will benefit PREMERA are reduced. In general, the public interest is probably not best served by having the Washington Foundation become a proponent or opponent of legislation. It is probable that such involvement would be perceived as a conflict by one or more segments of the public. Arguments that lobbying activities may inure to the benefit of the public may fall far short of overcoming these concerns. The

Commissioner should weigh the potential benefits that those assets would have provided to the public, when devoted to lobbying activities, against the public perception and very real possibility that the Washington Foundation will merely have become, at least in part, a lobbying vehicle for PREMERA and private interest groups. As a general matter, some factors that the Commissioner might consider are: (1) the scope of the lobbying, (2) the extent to which the lobbying would benefit PREMERA, (3) the economic and administrative resources that would be devoted to the lobbying activities, (4) the divisiveness of the issues on which the Washington Foundation can lobby, and (5) the extent to which the lobbying would promote the accessibility, affordability, and availability of health care in Washington.

The scope of the lobbying provisions have been modified from the provisions presented in the Original Transaction. In the Original Transaction, the Foundation Shareholder could lobby as long as it essentially furthered the interests of health insurers. In the Amended Transaction, however, section 5 of Article IV of the Articles of Incorporation permits lobbying activities that are consistent with the Washington Foundation's purposes so long as the lobbying activity would not be materially adverse to health insurers. This provision restricts the ability of the Washington Foundation to determine the best method by which to promote its purposes. For example, the Washington Foundation might determine that the best manner by which to fulfill its purposes would be to lobby for, or against, activities that would be materially adverse to health insurers. Moreover, the restriction is too broad because there may be lobbying activities that would be consistent with the Washington Foundation's purposes, but which PREMERA may consider to be materially adverse to health insurers. If PREMERA identifies specifically those issues on which the Washington Foundation should not be permitted to lobby, then this concern may be mitigated to the extent that those issues do not raise similar concerns. Otherwise, PREMERA may be able to influence indirectly the Washington Foundation's lobbying activities, especially if PREMERA funds the lobbying activities as discussed below.

Another factor to consider is the economic and financial resources to be devoted to lobbying. PREMERA suggests that it will fund[58] the lobbying activities of the Washington Foundation so that the proceeds from the Shares will not be required to be devoted to these activities. Overall, PREMERA's willingness to make contributions to the Washington Foundation for lobbying purposes may not be inconsistent with the public interest to the extent PREMERA does not influence the Washington Foundation's decisions regarding the issues on which to lobby. That is, PREMERA could affect the Washington Foundation's decisions through PREMERA's restriction that lobbying would not be permitted on issues that would be materially adverse to health insurers. This influence could be seen as affecting the independence of the Washington Foundation from New PREMERA. Moreover, PREMERA has not specified what it will contribute in subsequent years if the Washington Foundation decides to engage in lobbying activities. If PREMERA assures the Commissioner that it will fund the Washington Foundation's lobbying activities for this and future years, and PREMERA identifies specific issues, that do not raise other concerns, on which the Washington Foundation is prohibited from lobbying, then this issue may no longer be a concern to the Commissioner.

[58] The TGLA suggests that the Washington Foundation use a portion of its expenses provided by PREMERA in order to fund lobbying activities.

The Commissioner should consider the divisiveness of the issues on which the Washington Foundation can lobby, and the extent to which the lobbying would promote the accessibility, affordability, and availability of health care in Washington. With respect to both those issues, because the Washington Foundation has been made independent from New PREMERA in the Amended Transaction, the Board of Directors will be able to make an independent determination free from bias as to the issues on which to lobby in order to best promote its purposes, with the exception of PREMERA's indirect ability to influence the Washington Foundation's lobbying activities as described above.

Another concern is the potential cost to the Washington Foundation in terms of additional taxes that may be levied, and the likelihood that the Internal Revenue Service (the "IRS") would impose those taxes. As one of the Structural Issues presented to the applicant in February, 2003, PREMERA was given the opportunity to comment on whether (and if so, why) the Original Transaction should not make provision to prevent all lobbying, campaigning, or other political activity by the Charitable Organizations or the Foundation Shareholder (if one is retained). PREMERA did not respond. Moreover, PREMERA was given the opportunity to amend the Original Transaction, with respect to a closely-related issue, whether there would be two Foundation Shareholders and two Charitable Organizations, one of each for Alaska and Washington. Alternatively, PREMERA was asked to consider whether, if a structure were adopted that eliminated the Foundation Shareholder, the consideration should be delivered directly to the two Charitable Organizations. PREMERA neither responded to these inquiries nor provided an explanation as to why the current structure should be maintained.

PREMERA later purported to defend the one tier Foundation Shareholder structure in the Original Transaction as a measure intended to enable the Foundation Shareholder to qualify as a social welfare organization described in § 501(c)(4) of the I.R.C., thereby avoiding the excise tax imposed under § 501(c)(3). One of the fundamental concerns by Regulators and the Consultants was the Foundation Shareholder's ability to lobby. In order to provide added assurance that this entity would receive § 501(c)(4) tax status, and thus, be exempt from excise taxes, it was recommended by PREMERA that lobbying be permitted. One of the primary concerns with the Foundation Shareholder's ability to lobby was the fact that the Foundation Shareholder would not be independent from New PREMERA, and thus, the Foundation Shareholder would become a lobbying vehicle for New PREMERA. Now that the Washington Foundation is independent, concerns about lobbying have been reduced considerably, with the exception of those concerns identified above. That is, if the IRS requests that the Articles of Incorporation be amended so as to prevent any restriction on lobbying, then it need not be contrary to the public interest to remove the lobbying restriction. A related issue is whether PREMERA should prohibit the ability of the Washington Foundation to amend its Bylaws, as discussed *infra* at section III.C.2.c. Furthermore, because the Washington Foundation is independent from New PREMERA, and lobbying in general is not a particular concern, there was no need to maintain the one tier structure in the Original Transaction. A consequence of this modification was the lack of a rational reason to continue treating the states of Alaska and Washington as a single state or single shareholder, as described *infra* at section IV.C.4.a.

While these issues may not, by themselves, be dispositive as to whether the Amended Transaction should be approved, they are material considerations to be evaluated in the context of the Amended Transaction as a whole.

(3) Prudent Person Rule

Section 2 of Article VII of the Articles of Incorporation propose to exempt the directors from WASH. REV. CODE ANN. §§ 11.100.010–.140, "Investment of Trust Funds," which is essentially the codified version of the common law "prudent person" rule standard. At the time of the filing of C&B's Final Report, the language with respect to this exemption and that of the "prudent person" rule was unduly broad. PREMERA has amended this exemption so as to specifically state what provisions codified in WASH. REV. CODE ANN. Chapter 11.100 should not apply to the Board of Directors. Even with PREMERA's specificity, the provisions cited by PREMERA may be too broad.

It should be noted that, funding the Washington Foundation with New PREMERA stock instead of cash may be the only practicable method of effectuating the Transaction as proposed. Moreover, the Transaction ensures that the Washington Foundation's "eggs" will remain in "one basket" only temporarily, because it requires the Washington Foundation to divest itself of the Shares pursuant to a divestiture schedule. In addition, as the Articles of Incorporation are proposed, the Washington Foundation's directors will remain subject to the prudent person rule with respect to all of the Washington Foundation's assets other than the Shares (*e.g*, the manner in which the Washington Foundation's directors invest the proceeds from the divestiture of the Shares). Further, the Board of Directors would remain subject to all other applicable duties such as the duty to act in good faith and in a manner the directors reasonably believe to be in the best interest of the corporation.[59] Thus, if limited solely to the Washington Foundation's concentration of assets in New PREMERA stock (as PREMERA asserts is the intent), this provision ultimately may not raise fundamental concerns, but only to the extent that the exemptions are further limited to requirements relating to diversification and the holding of speculative investments. The inability of the Washington Foundation to diversify its portfolio immediately may not give rise to the feared liability. The common law duty to diversify trust assets is subject to at least two exceptions: (1) an express provision by the settlor relieving the trustee of the duty to diversify, or (2) circumstances dictating that it is not prudent to diversify. The Regulators' approval of the Articles of Incorporation on the public's behalf should serve to protect the Board of Directors from any liability under the "prudent person" standard because the settlor, in this case, is arguably the public. It may even be appropriate to recite, in any order approving the Amended Transaction, that the Washington Foundation and its directors are not at liberty *ab initio* to achieve the desired diversification and cannot be held accountable for such inability for some specified period of time. It is important, however, to assure that the exemptions proposed by PREMERA not go further than exemptions required to limit liability as a result of diversification or holding speculative investments.

The Articles of Incorporation propose to exempt the directors from: (a) all requirements of WASH. REV. CODE ANN. 11.100.020, (b) the 10% limit of WASH. REV. CODE ANN. 11.100.023, (c)

[59] *See* WASH. REV. CODE ANN. § 24.06.153(1) (listing the duties of corporate directors and officers).

any duty to beneficiaries under WASH. REV. CODE ANN. 11.100.045, (d) the duty to diversify investments under WASH. REV. CODE ANN. 11.100.047, (e) any duty to diversify, or to exercise due care and prudence in the disposition or retention of the Shares, under WASH. REV. CODE ANN. 11.100.060, (f) the duties of WASH. REV. CODE ANN. 11.100.130 if deemed applicable to directors, (g) the requirements of WASH. REV. CODE ANN. 11.100.140, and (h) any other or successor statute of similar import. These exemptions may be unnecessarily broad. Rather than restating each of the foregoing provisions, C&B will discuss in what manner, if any, each provision exceeds PREMERA's apparent rationale for the exemption.

First, WASH. REV. CODE ANN. 11.100.020 does not compel a fiduciary to diversify a trust's corpus. It does, however, require the fiduciary to give due consideration to the "role that the proposed investment or investment course of action plays within the overall portfolio of assets."[60] Thus, even if this provision were interpreted so as to compel a fiduciary to diversify a trust's corpus, the foregoing provision gives the fiduciary the discretion of deciding whether to diversify the trust. Second, WASH. REV. CODE ANN. 11.100.023 limits the amount of speculative investments that can be held in the trust to 10%. Although this provision may not apply to the Shares, because they are the assets with which the Washington Foundation will be formed, if it did apply, this may cause undue pressure on the Board of Directors to sell the Shares. Thus, the limitation of this provision is not against the public interest. Third, the Board of Directors is exempt from any duty to beneficiaries under WASH. REV. CODE ANN. 11.100.045. This exemption is clearly contrary to the purposes set forth in the Articles of Incorporation. Those purposes are to promote the health of the Washington public, who are essentially the beneficiaries or owners of the Shares to be held by the Washington Foundation. Any decision of the Board of Directors must take into account those interests, which is similar to the requirement imposed in WASH. REV. CODE ANN. 11.100.045. Fourth, the Board of Directors is exempt from the duty to diversify investments under WASH. REV. CODE ANN. 11.100.047. Although this provision references specifically the duty to diversify, it also allows the fiduciary not to diversify if "the fiduciary reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."[61] This provision may provide sufficient flexibility to the fiduciary so as not to compel diversification. PREMERA's exemption may be appropriate in order to be certain that this provision is not misconstrued. Fifth, the Board of Directors is exempt from any duty to diversify, or to exercise due care and prudence in the disposition or retention of the Shares, under WASH. REV. CODE ANN. 11.100.060. This exemption is again far too broad. Any exemption should be narrowly tailored to prevent the fiduciary from being compelled to diversify, if at all, under this section rather than exempting the fiduciary from all other types of duties. Sixth, the Board of Directors is exempt from the duties of WASH. REV. CODE ANN. 11.100.130 if deemed applicable to directors. This provision merely states that fiduciaries other than trustees are liable to the same extent as trustees. There is no reason to exempt the Board of Directors from this provision, if applicable. Seventh, the Board of Directors is exempt from the requirements of WASH. REV. CODE ANN. 11.100.140, which requires notice to

[60] WASH REV. CODE ANN. § 11.100.020(1).

[61] WASH REV. CODE ANN. § 11.100.047.

be provided in cases of certain material transactions.[62] This provision is unnecessary and unduly burdensome on the fiduciary and may hinder the disposition of the Shares in a manner which maximizes value. Thus, this exemption may be appropriate.

In sum, the only exemptions from WASH. REV. CODE ANN. Chapter 11.100 that may be appropriate are as follows: (1) the 10% limit of WASH. REV. CODE ANN. 11.100.023, (2) the duty to diversify investments under WASH. REV. CODE ANN. 11.100.047, (3) duties under WASH. REV. CODE ANN. 11.100.060, to the extent that PREMERA revises this provision to limit the exemption to any diversification requirement, and (4) the requirements of WASH. REV. CODE ANN. 11.100.140 concerning certain material transactions. Although the foregoing problems alone may not be sufficient to compel disapproval, they are an additional factor to consider.

(4) Indemnification, Conflicts with Bylaws, and Presumption of Assent

Although some provisions of the Articles of Incorporation provide protections which exceed those envisioned in the applicable statutory requirements for indemnifying directors and officers, the indemnification provisions are no longer of particular concern because the Board of Directors is independent from that of New PREMERA. Moreover, the Articles of Incorporation no longer conflict with the Bylaws with respect to the vote required to amend the organizational documents, although both agreements conflict with other documents as discussed later in this Supplemental Report. Lastly, the presumption of assent provision no longer conflicts with applicable law or with PREMERA's rationale for such a provision.

(5) Amendment of Articles of Incorporation and Bylaws

Articles IX and X of the Articles of Incorporation state that neither the Bylaws nor the Articles of Incorporation, respectively, may be amended without a vote of three-fourths of the directors then in office, and advance written approval of the Attorney General. An exception is made for amendments to Article XI ("Registered Office and Agent"), which does not require the Attorney General's approval to be amended. It should be noted that a further restriction is imposed on the amendment of Article III ("Purposes and Powers"), by preventing an amendment that is inconsistent with supporting health initiatives for the residents of the State of Washington. The requirement that three-fourths vote is required for any amendment reduces the flexibility that the Board of Directors will have in modifying these agreements to meet certain needs of the Washington Foundation. Rarely do corporate documents require a supermajority vote of three-fourths of the directors then in office to amend every provision of the organizational documents. Moreover, with the added protection that the Attorney General is required to approve any amendment, there is even less reason to require a supermajority vote of three-fourths of the directors in order to amend the Articles of Incorporation and the Bylaws. There may, however, be specific provisions that are so fundamentally important that it is appropriate to require such a supermajority vote. With respect to the Articles of Incorporation, a supermajority vote of three-fourths of the directors would be

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[62] The code refers to those transactions as a significant nonroutine transaction[s]. WASH REV. CODE ANN. § 11.100.140(2).

reasonable for Article III ("Purposes and Powers"), Article IV ("Limitations and Conditions"), Article IX ("Bylaws"), and Article X ("Amendment"). With respect to the Bylaws, a supermajority vote of three-fourths of the directors would be reasonable for Article II ("Members"), Article III ("Board of Directors") and section 9.6 ("Amendment of Bylaws") of Article IX. Despite the foregoing concerns, these provisions may not, by themselves, compel disapproval of the Transaction. They are, however, an additional factor for the Commissioner to consider in making his determination.

(6) Board of Directors' Qualifications

Section 3.2 of Article III of the Bylaws provide the qualifications that an individual must meet in order to serve on the Board of Directors, including whether a candidate is excluded automatically from serving on the Board of Directors. Generally, the exclusions encompass a wide range of individuals that may have the appropriate experience to govern the Washington Foundation. Nonetheless, one exclusion in particular is extremely troublesome. PREMERA has excluded those individuals who are a member "of any hospital or hospital association or medical association in Washington." Such an exclusion is quite puzzling considering that PREMERA states that the Board of Directors should have experience in health care or public health. This is a fundamental corporate governance question that will affect both the decisions of the Attorney General and the Commissioner. The Board of Director's composition is of utmost importance because the board will ultimately make the decisions regarding the disposition, control, and distribution from the sale, of the Shares. Limiting the members that will serve on the Board of Directors will prevent the public from receiving the best representation available to protect its interest. That is, the Attorney General may be compelled to reject individuals who are more qualified than others merely because of this exclusion, thus, preventing the most qualified individuals from representing the public. The Commissioner may have sufficient grounds to reject the Amended Transaction on this basis alone. At a minimum, he may want to consider requiring elimination of these provisions.

(7) First Board, Second Board, and Third Board

In section 3.5.2 of Article III of the Bylaws, PREMERA has installed a three board system for the Washington Foundation. The initial directors (the "First Board") will be appointed by PREMERA prior to any regulatory approvals for purposes solely of "creating the [Washington Foundation] and applying to the [IRS] for recognition of the organization's tax-exempt status," as indicated in footnote one to Article VI of the Articles of Incorporation. If all state and regulatory approvals have been obtained, then the First Board will resign and the Attorney General will appoint another set of temporary directors (the "Second Board"), which will then continue the process of attaining tax-exempt status. During the term of the Second Board, the Attorney General will seek individuals to serve on the third board (the "Third Board") and may utilize processes, and may consult with various individuals and groups, as is appropriate under the circumstances. This Third Board will in effect be the first permanent and full board that will represent the interests of the public. Although the foregoing generally serves the public interest, PREMERA prevents the establishment of the Third Board until after the IPO. This provision is inappropriate and raises a fundamental concern regarding corporate governance. If the Attorney General finds qualified individuals to appoint to the Third Board prior to the IPO, then there is not a good reason to prevent such installation. It may be argued that the Second Board should make the decision as to what portion of the Shares to be included in, and other decisions regarding, the IPO, because the Third Board may not have sufficient time to complete its due diligence. This argument, however, has little merit, because the Attorney General, presumably, would appoint the Third Board sufficiently in advance of the IPO in order for the appropriate due diligence to be conducted. Again, the Commissioner may have sufficient grounds to reject the Amended Transaction on this basis alone. Alternatively, at a minimum, he may want to consider requiring elimination of this limitation.

(8) Investment Committee

In section 8.5 of Article VIII of the Bylaws, PREMERA has provided for a standing finance and investment committee (the "Investment Committee") upon the appointment of the First Board. The Investment Committee "shall include directors who have substantial business or financial management experience, such as experience as a board member or executive officer of a public company or other comparable experience." The Investment Committee "may exercise all the powers and functions of the Board [of Directors] in the management, control, and disposition of the [Washington Foundation's] investments, including without limitation, (a) the [Shares] and (b) any proceeds, including without limitation, income on such proceeds as invested and reinvested, from the sale of [the Shares]." There are several serious concerns raised by section 8.5. The Investment Committee is to be established upon PREMERA's appointment of the First Board. The First Board, however, is intended to perform ministerial functions only, and thus, there is no need to establish the Investment Committee at that time. Moreover, because the First Board will be appointed by PREMERA, the establishment of the Investment Committee at that time raises the issue of whether the Washington Foundation is truly independent from New PREMERA. The second concern is the strict qualifications required for members on the Investment Committee. The level of experience required is much greater than the qualifications to be a member of the Board of Directors. The Attorney General may determine that there are individuals that have relevant business experience to serve on the Investment Committee, but do not have experience with a public company as currently required. Moreover, the Washington Foundation is not a public company. Thus, it seems unnecessary that the directors have public company experience. The third, and perhaps most serious concern, relates to the powers granted to the Investment Committee. The Investment Committee has the power, without approval from the Board of Directors, to determine the control, and disposition, of the Shares. This is contrary to the Washington Foundation's core function, which is to balance the health care needs of the Washington public with the maximization of the proceeds to be received from the disposition of the Shares. The Investment Committee does not have the expertise required to make this decision, nor should it determine alone this fundamental purpose of the Washington Foundation. If the Investment Committee were structured in a manner merely to provide recommendations to the Board of Directors as a whole, then the Investment Committee would serve an important function while still allowing the Board of Directors to balance the needs of the public with the recommendations from the Investment Committee. As currently proposed, these provisions may furnish the Commissioner a sufficient basis to disapprove the Transaction. Or, he may elect to require the removal of the offending requirements.

c. PREMERA's Restated Articles of Incorporation

Article XII of PREMERA's Restated Articles of Incorporation provide that the transfer of the Shares to the Washington Foundation will occur only upon the Washington Foundation's receipt of § 501(a) tax-exempt status, and if the Washington Foundation has not amended, altered, or repealed its respective Articles of Incorporation or Bylaws. The conditions imposed by PREMERA in its Restated Articles of Incorporation on the transfer of Shares are unnecessary and burdensome. As a preliminary note, the provisions seem to require that both of the Foundations must satisfy the conditions in order to receive and use the Shares. It is inappropriate to require the Washington Foundation to be subject to whether the Alaska Foundation satisfies these conditions. PREMERA's prohibition of the Washington Foundation from amending, altering, or repealing its respective Articles of Incorporation or Bylaws impedes the Washington Foundation's ability to make changes to its organizational documents in order to satisfy possible IRS concerns when trying to achieve § 501(c)(4) tax status. Typically when an organization seeks tax exemption from the IRS, that organization meets informally with the IRS in a pre-submission conference in order to determine what changes, if any, should be made to the organizational documents prior to the organization's formal application. Even after the application is submitted, the Washington Foundation may be required to amend its organizational documents based on the response from the IRS. PREMERA has effectively prohibited the Washington Foundation from having this flexibility when trying to achieve tax-exempt status. Moreover, this restriction conflicts with the Washington Foundation's Articles of Incorporation which expressly permit amendments to the Articles of Incorporation and Bylaws. Regardless of the foregoing problems with PREMERA's Restated Articles of Incorporation, it does seem that PREMERA's overall intent is that the Washington Foundation receive tax-exempt status. Thus, the potential negative effect of these provisions may have been merely an oversight. If this was not merely an oversight on PREMERA's part, then these provisions may not be in the public interest in light of the fact that PREMERA has imposed the liability for tax consequences stemming from the failure to achieve § 501(c)(4) status on the Washington Foundation. That is, if PREMERA requires that the Washington Foundation be responsible for any excise or other taxes associated with not achieving § 501(c)(4) status, then PREMERA must also give the Washington Foundation the flexibility to satisfy the requirements of the IRS. Moreover, the apparent goal of all of the parties is that the Shares be transferred to a § 501(c)(4) organization with the purpose of supporting health initiatives in the State of Washington. These purposes can be monitored effectively by the Washington Attorney General, acting as *parens patriae*, without the need of conditioning any transfer of the Shares, other than the general condition that assets be used to support health initiatives in the State of Washington.

d. Transfer, Grant, and Loan Agreement/Stock Restrictions Agreement

Although PREMERA has eliminated the Stock Restrictions Agreement from the Amended Transaction, it has replaced that agreement with a similar agreement entitled the Transfer, Grant and Loan Agreement. As a preliminary note, the recitals reference Acknowledgments and Consents of the Foundations that will be executed at some unknown time (the "Consents"). It is unclear as to what PREMERA means by Consents. With the exception of the provisions relating to the grant and potential loan of initial capital by PREMERA to the Washington Foundation, many provisions of the agreement is either redundant, or inconsistent, with other agreements. One of the problems with the TGLA, as was true with the Stock Restrictions Agreement, was that PREMERA had not provided for the allocation of the Shares between the states as discussed *infra* at section IV.C.5. In addition, section 2.01 of Article II of the TGLA provides for grants up to $250,000 to the Washington Foundation to be used for initial start-up expenses, and an additional loan of up to $250,000 for the same purpose if the grants are expended completely. The TGLA, however, contains other provisions that have been repeated numerous times in other agreements and create unnecessary additional complexities and inconsistencies for the Amended Transaction.

Article I merely restates the Washington Foundation's obligation to sell the Shares in accordance with the VTDA and the Washington Foundation's obligation to expend the proceeds for the purposes set forth in the Washington Foundation's organizational documents. Aside from this redundancy, Article I creates several inconsistences with the Washington Foundation's organizational documents. First, Article I states that the Washington Foundation may make distributions to § 501(c)(3) organizations only, whereas section 2 of Article III of the Washington Foundation's Articles of Incorporation state that distributions may be made to any tax-exempt entities under the I.R.C., which necessarily includes § 501(c)(4) corporations. Similarly, section 3.04 of Article III of the TGLA requires distribution of the assets upon the Washington Foundation's dissolution to § 501(c)(3) organizations. Second, the Washington Foundation has the ability to amend its purposes, but the purposes set forth in the TGLA would change upon an amendment to the Washington Foundation's Articles of Incorporation. Third, section 1.03 of Article I of the TGLA prohibit lobbying, however, the Washington Foundation's Articles of Incorporation already provide for lobbying in certain limited circumstances, as discussed *supra* at section III.C.2.b.(2).

Fourth, section 1.03 of the TGLA prevents PREMERA's assets from being used for "activities, programs or initiatives that likely would result in material adverse changes in the operations of entities engaged in the business of providing coverage of or the administration of health benefits, including, without limitation, any health insurer, health carrier, health maintenance organization or health plan in Washington or Alaska." This provision seems to be another inconsistency with the Washington Foundation's Articles of Incorporation because no such limitation exists in that document. And, even if there were such a restriction, it would not be in the public interest to handicap the Washington Foundation's decisions, which might ultimately be in the best interest of the public despite having an adverse effect potentially on New PREMERA. Furthermore, that provision is so broad that any activity conducted by the Washington Foundation may be considered adverse to New PREMERA. Aside from the foregoing public interest problems, the provision is unnecessary as a practical matter because it is unlikely that the Washington Foundation, which will be New PREMERA's largest shareholder for some period of time after the conversion, will engage in activities that will be adverse ultimately to the value of the Shares. Given the importance of this issue to a core public implication of the conversion, the Commissioner may conclude that it is a partial or sufficient basis for disapproval of the Transaction.

Article III is also unnecessary and repetitive for several reasons. First, section 3.01 of Article III restates Article X of the Washington Foundation's Articles of Incorporation, with respective to amendments to that document. Second, section 3.02 indicates that the Washington Foundation is to enter into a grant agreement with any organization to which funds are distributed. This grant agreement is to include, *inter alia*, that: (1) the funds are to be used for the Washington

Foundation's purposes listed in the TGLA, (2) the Washington Foundation shall have injunctive relief, (3) the Attorney General will have injunctive relief and New PREMERA, as a third-party beneficiary, has a right to pursue injunctive relief, (4) the organizations provide the Washington Foundation annually a summary of the programs, (5) recognize the requirement that the organization maintain § 501(c)(3) status, and (6) provide the Washington Foundation with the right to audit the organization's charitable activities. There are apparent inconsistencies between the fourth provision required to be included in the grant agreement and the Articles of Incorporation. As noted previously, the Articles of Incorporation permit the distribution of the Washington Foundation's assets to any tax-exempt organization, but the grant agreement suggests that only § 501(c)(3) corporations are to receive distributions. Aside from that inconsistency, under the TGLA, New PREMERA has the right to pursue injunctive relief. PREMERA has not indicated under what authority New PREMERA should be considered a third-party beneficiary.[63] In fact, the public, as the owners of the Shares, should not be under scrutiny by New PREMERA. The only beneficiary is the Washington public. Although the requirement that the Washington Foundation enter into a grant agreement in the first instance, or the specific provisions required to be included in the grant agreement, are unnecessary or inconsistent, they may not be of such significance in the context of the conversion as a whole to compel its disapproval.

e. PREMERA's Articles of Dissolution and Plan of Distribution/PBC's Articles of Dissolution and Plan of Distribution/LifeWise of Washington's Articles of Dissolution and Plan of Distribution

PREMERA's proposed Articles of Dissolution comply with WASH. REV. CODE ANN. 24.06.275 ("Articles of Dissolution"). PREMERA will also be required to comply with WASH. REV. CODE ANN. 24.06.260 ("Voluntary Dissolution") and WASH. REV. CODE ANN. 24.06.280 ("Filing of Articles of Dissolution"). PBC's proposed Articles of Dissolution comply with WASH. REV. CODE ANN. 24.03.240 ("Articles of Dissolution"). PBC will also be required to comply with additional procedural requirements, such as WASH. REV. CODE ANN. 24.03.220 ("Voluntary Dissolution"), WASH. REV. CODE ANN. 24.03.245 ("Filing of Articles of Dissolution"), and WASH. REV. CODE ANN. 24.03.230 ("Plan of Distribution"). In the Final Report, C&B's comments and suggestions were similar for each of the Plans of Distributions of PREMERA, PBC, and LifeWise. The comments in this section will reference PREMERA's Plan of Distribution, but will apply equally to those of PBC and LifeWise of Washington.

As compared to PREMERA's proposed Plan of Distribution in the Original Transaction, PREMERA seems to have modified the Plan of Distribution in the Amended Transaction based on C&B's suggestion in its Final Report that the Plan of Distribution restricts the use of PREMERA's remaining assets upon distribution to charitable, benevolent, or similar purposes. PREMERA, however, has also restricted the use of the assets to additional specific purposes, which are the same as those purposes enumerated in the Washington Foundation's Articles of Incorporation. Restricting the use of PREMERA's assets, specifically, to that enumeration is contrary to the public interest

[63] *But see PostleWait Constr. v. Great Am. Ins. Cos.*, 106 Wash. 2d 96, 99 (1986) (quoting that "[t]he creation of a third-party beneficiary contract requires that the parties intend that the promisor assume a direct obligation at the time they enter into the contract").

because the restriction prevents the Washington Foundation from having the flexibility to amend its purposes if deemed necessary. For example, the Washington Foundation may determine that it is necessary to amend its Articles of Incorporation in response to recommendations made by the IRS that make the attainment of § 501(c)(4) status more likely. Moreover, such restrictions contradict Article X of the Washington Foundation's Articles of Incorporation, which permit amendments to its purposes. Thus, although the Washington Foundation may amend its purposes, the restrictions imposed by the Restated Articles of Incorporation may prohibit such amendments. Like the TGLA, as discussed *supra* at section III.C.2.d, the Plan of Distribution also includes the restrictions against the use of proceeds that are adverse to health insurers. As determined in that section, the Commissioner may conclude that the importance of this issue is a partial or sufficient basis for disapproval of the Transaction.

f. Other Agreements

As discussed in C&B's Final Report, the LifeWise of Washington/New LifeWise of Washington Transfer of Assets Agreement,[64] the PBC/PBC-AK Transfer of Assets Agreement,[65] the PBC/New PBC Transfer of Assets Agreement,[66] and the PREMERA/New PREMERA Transfer of Assets Agreement[67] comply with applicable law. To the extent, however, that the exhibits to the foregoing documents are analyzed separately in this Supplemental Report, the comments to those documents are equally applicable to those documents attached as exhibits to the foregoing Transfers of Assets Agreements.

3. Federal Law

As discussed more fully in C&B's Final Report, the Amended Transaction generally is not governed in any material respect by federal law . There will, of course, be provisions of the I.R.C. that will have a material impact on the Amended Transaction and its consequences. These matters are addressed more fully in the tax analysis furnished by PwC. There are certain filing requirements imposed by the Hart-Scott-Rodino Antitrust Improvement Act of 1976 ("HSR") with which PREMERA will likely have to comply. Furthermore, representatives of the Federal Trade Commission ("FTC") and Department of Justice ("DOJ") may screen the Amended Transaction under the Clayton Act for likely anticompetitive effects. Similarly, the Attorney General, in her advisory role, will assist the Commissioner in evaluating the effect of the Amended Transaction on competition. It is, however, unlikely that the FTC or DOJ will challenge the Amended Transaction.

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[64] LifeWise/New LifeWise Transfer of Assets Agreement, Form A: Exhibit A-4A (Sept. 26, 2002), *available at* http://www.insurance.wa.gov/special/premera/filing/ExhibitA_of_ExhibitA-4.pdf.

[65] PBC/PBC-AK Transfer of Assets Agreement, Form A: Exhibit G-11 (Sept. 26, 2002), *available at* http://www.insurance.wa.gov/special/premera/filing/ExhibitG-11.pdf.

[66] PBC/New PBC Transfer of Assets Agreement, Form A: Exhibit G-12 (Sept. 26, 2002), *available at* http://www.insurance.wa.gov/special/premera/filing/ExhibitG-12.pdf.

[67] PREMERA/New PREMERA Transfer of Assets Agreement, Form A: Exhibit G-13 (Sept. 26, 2002), *available at* http://www.insurance.wa.gov/special/premera/filing/ExhibitG-13.pdf.

There are no other general regulatory requirements or necessary approvals applicable to the Amended Transaction under federal law.

D. Fairness to Policyholders, Providers, and Public

As discussed *supra* at section III.C.1.a, the Holding Company Acts require the Commissioner to evaluate six potentially disqualifying factors with respect to a change of control. The Commissioner is required to approve the Transaction unless he makes one of the following fact-findings: (1) after the change of control, the domestic health carrier would not be able to satisfy a domestic health carrier's registration requirements, (2) there is substantial evidence that the acquisition would significantly lessen competition or tend to create a monopoly in insurance in Washington, (3) the acquiring party's financial condition is such as might jeopardize the health carrier's financial stability or prejudice its subscribers' interest, (4) the plans or proposals that the acquiring party has to liquidate the health carrier, sell its assets, consolidate or merge it with any person, or to make any other material change in its business or corporate structure or management are unfair and unreasonable to the health carrier's subscribers, and not in the public interest, (5) the competence, experience, and integrity of those persons who would control the health carrier's operations are such that it would not be in the interest of the health carrier's subscribers, and of the public, to permit the acquisition of control, or (6) the acquisition is likely to be hazardous or prejudicial to the insurance-buying public.[68]

The first two of these factors relate to licensing and registration requirements and the Antitrust Inquiry, which have already been discussed *supra* at section III.C.1.a. As concluded, PREMERA is able to satisfy the licensing and registration requirements. Secondly, Dr. Leffler, in his Supplemental Antitrust Report, has advised the OIC that PREMERA's market power in eastern Washington lays the predicate for a potential increase in premium rates. The remaining four factors are analyzed in this section, because each generally relates to an analysis of the Amended Transaction's fairness to policyholders, providers, and the public, which was a separate assignment under Stage One.

1. Impact on Financial Condition

With respect to the third of six potentially disqualifying facts, the Commissioner must determine whether New PREMERA's financial condition might jeopardize the acquired domestic health carriers' financial stability or prejudice their subscribers' interests.[69] The Transaction's potential impact on PREMERA's financial condition is the subject of extensive consideration by other Consultants. The conclusions produced by those analyses are fundamentally instructive as to the Amended Transaction's compliance with this substantive requirement. Some general comments, however, will serve to place this issue in perspective.

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[68] *See supra* note 41 and accompanying text.

[69] WASH. REV. CODE ANN. § 48.31C.030(5)(a)(ii)(C)(I); *see* WASH. REV. CODE ANN. § 48.31B.015(4)(a)(iii) (substituting "policyholder" for "subscriber" under the IHCA).

As noted in the Final Report, the Transaction will entail significant costs, which are not, however, expected to be material to PREMERA's financial viability. The conversion will also impose upon New PREMERA recurring and continuing costs inherent in operating as a publicly-traded company. And there will be the one-time cost of "going public" that is also likely to be substantial. In the aggregate, these initial and ongoing conversion costs are not expected to impair PREMERA's financial viability, but they will constitute material increases in operating costs. Of somewhat greater concern is the possibility that the Transaction may impose substantial new liabilities on New PREMERA.

As a result of the conversion, PREMERA's premium tax obligation in Alaska will increase from 2% to 2.7%, but it has provided assurances that it will not raise premium rates to Alaska customers to recoup these additional taxes. Moreover, key among the possible new liabilities are potentially adverse federal income tax consequences. PREMERA has not been exempt from federal income taxes since 1987, and has never been exempt from Washington state taxes.[70] However, in 1987, when Congress revoked the availability of tax exemptions to BCBS plans under I.R.C. § 501(c), it did provide certain other favorable tax treatments for those plans, such as certain deductions and favorable treatment of unearned premium reserves under I.R.C. § 833(b). The continued availability of those benefits is subject to a condition that the company not experience a material change in operations or structure.[71] Preliminary indications are that the loss of these benefits would be a materially adverse consequence for PREMERA. Rather than being subject to the lower effective tax rate of 20%, in that event PREMERA would be subject to the typical corporate federal income tax rate of 35%.[72] However, PREMERA has alternative minimum taxes, NOLs, and other deferred tax items that can be used temporarily to offset any such tax increase.[73] Nonetheless, these credits are projected to expire in 2007, and thus, PREMERA could be subject to these higher effective tax rates at that time and thereafter.[74]

Although PREMERA's tax consultant, Ernst & Young ("E&Y"), has provided a "more likely than not" draft short-form opinion indicating that they do not believe that the Transaction will result in such a material change,[75] PREMERA has not provided a substantive opinion underlying the draft opinion, otherwise referred to as a "long-form opinion." Recently, the Consultants have learned that PREMERA may not provide the final E&Y opinion, and PwC has advised the Consultants to assume in their analysis that PREMERA will lose the deduction. Moreover, PwC has suggested that a "more likely than not" tax opinion is viewed as a low level of assurance for a transaction of this

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[70] Per PREMERA's management.

[71] I.R.C. § 833(c)(2)(C).

[72] PwC, Report to the OIC on Tax Matters in Connection with the Proposed Conversion of PREMERA, at 14 (Oct. 27, 2003) (on file with C&B) [hereinafter "PwC Tax Report].

[73] *Id.*

[74] *Id.*

[75] *Id.*

type.[76] Despite the draft opinion provided by E&Y, PwC states that the risk of PREMERA being deemed by the IRS to have experienced a material change is significant.[77] This is a point of substantial concern due to the uncertainty surrounding this issue, the lack of direct authority, the view of the IRS, and the unavailability of a stronger opinion by E&Y.[78] The Consultants conducted an analysis of the potential magnitude of the possible adverse tax consequences and the effect, if any, that they would have on New PREMERA's financial condition. PwC has indicated that those effects are material as evidenced by the deductions PREMERA has taken over the last few years totaling $32 million in 2002, $50 million in 2001, $50 million in 2000, and $30 million in 1999.[79] Although PREMERA asserts that any potential tax liability would not be passed on to subscribers,[80] there is no assurance of this fact. Furthermore, such a material change may also materially affect New PREMERA's value, as noted by Blackstone.[81] The effect of the loss of the I.R.C. § 833 deduction will be an immediate and continuing increase in tax liability reported on PREMERA's GAAP financial statement (even if offset temporarily by the utilization of other favorable tax measures). PwC has also identified other adverse tax events that may be triggered by the Transaction; however, either those are immaterial, or PREMERA has more authority to support its position that those tax provisions will not be triggered.[82] On the other hand, PREMERA has eliminated the Indemnification Agreement through which it intended originally to make the Foundations liable for any tax consequences resulting from the Transaction.[83]

Overall, the Commissioner has sufficient evidence on the record to consider, in deciding whether to disapprove the Transaction, the expected material adverse financial consequences, consisting mainly in increased costs or liabilities, such as the rise in Alaska premium taxes, the increase in operating costs, and the potential loss of the benefit of I.R.C. § 833(b). It is left to his discretion to determine whether the magnitude of this result justifies disapproval of the Amended Transaction.

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[76] *Id.* at 12.

[77] *Id.* at 15.

[78] *Id.* at 14–15.

[79] *Id.* at 13 n.9.

[80] *Id.* at 12.

[81] Blackstone, Valuation and Fairness of the Proposed Conversion, at 9 (Oct. 27, 2003) (on file with C&B) [hereinafter "Blackstone Valuation and Fairness Report"].

[82] PwC Tax Report, *supra* note 72, at 3–7.

[83] *See* PREMERA Answers Consultant Exhibit B Questions, at 0030092 (Feb. 10, 2003) (on file with C&B) (stating that PREMERA considers the scope of the Indemnification Agreement "to require the Foundation Shareholder to indemnify PREMERA from the potential loss of the I.R.C. § 833(b) deduction or other future tax liabilities as a result of the loss of an existing tax status").

2. Fairness and Reasonableness of PREMERA's Proposal

As to the fourth potentially disqualifying fact, the Commissioner must determine whether New PREMERA's plans to sell assets, consolidate or merge with any person, or to make any other material change in its business or corporate structure or management are unfair and unreasonable to subscribers or policyholders, and not in the public interest.[84] Overall, this factor involves the analysis of many different facets of the Amended Transaction. As a starting point, the standard by which this determination is to be made should be considered. Additionally, consideration of the meaning of "public interest" may be instructive. This determination entails the application of various principles of statutory construction, such as the ordinary meaning of the term, policy considerations, and the doctrine of *in pari materia*. In due course, this element of the Holding Company Acts also requires an analysis of the impact of the Amended Transaction on availability, accessibility, and affordability of health insurance, including negative financial impacts on subscribers, policyholders, and providers, and the consequences for uninsured and underinsured populations. Lastly, this factor also delves in greater detail into management's due diligence obligations.

a. Balancing Test, Ordinary Meaning of Public Interest, and Policy Considerations

As a practical matter, in making a determination as to whether the Transaction is unfair and unreasonable to subscribers or policyholders, and not in the public interest, the Commissioner may elect to balance the Transaction's anticipated adverse consequences to the subscribers, policyholders, and the public with the Transaction's potential benefits. This balancing test has been recognized implicitly by the Supreme Court of Kansas under a statute substantially similar to the Holding Company Acts.[85]

Additionally, reference should be made to the ordinary meaning of the terms "unfair," "unreasonable," and "public interest," because these terms are undefined within the Holding Company Acts.[86] All three terms are in common usage and have accepted meanings. Of course, unfair is the opposite of fair, and unreasonable is the opposite of reasonable. "Fair" means free from

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[84] *See* WASH. REV. CODE ANN. § 48.31C.030(5)(a)(ii)(C)(II); *see also* WASH. REV. CODE ANN. § 48.31B.015(4)(a)(iv).

[85] The Insurance Commissioner can "balance" the insurer's business interests with the public interest in determining that the policy of protecting the public interest outweighs any of the potential positive effects on the insurer's business interests. *See Blue Cross & Blue Shield of Kan., Inc.*, 75 P.3d 226, 243–44 (2003). The Insurance Commissioner did not improperly shift the burden of proof to the applicant by merely weighing the evidence and finding that the Insurance Commissioner's consultant's evidence was more weighty and persuasive than that of the applicant. *Id.* at 252–53.

[86] *See State v. Smith*, 117 Wash. 2d 263, 271, 814 P.2d 652, 655 (1991) (stating the Washington Supreme Court's rule that "[w]ords are given the meaning provided by the statute or, in the absence of specific definition, their ordinary meaning"); *see also State v. Votava*, 149 Wash. 2d 178, 183, 66 P.3d 1050, 1053 (2003) (following *Smith*).

favor toward either or any side.[87] "Fair implies an elimination of one's own feelings, prejudices, and desires, so as to achieve a proper *balance of conflicting interests*."[88] "Reasonable" means "being in accordance with reason."[89] According to *Black's Law Dictionary*, "public interest" is "something in which the public as a whole has a stake."[90] The ordinary meanings of the undefined statutory terms may be of limited assistance, but suggest that the requirement that New PREMERA's plans not be unfair and unreasonable to subscribers or policyholders, and not contrary to the public interest,[91] requires that any purported benefits of the Transaction *to the company* must not, on balance, prejudice subscribers or policyholders, and the public. That is, any purported benefits to subscribers, policyholders, and the public, must be balanced against any negative effects to those constituencies, to determine whether, overall, they will be prejudiced as the result of a transaction that the converting company believes to be in its best interest or in the best interest of management.

It is worth noting that the Commissioner's evaluation of whether the Amended Transaction is unfair and unreasonable to subscribers or policyholders, and not in the public interest, is not limited by the business judgment rule. Under the business judgment rule, a court will not substitute its judgment for that of management, as long as appropriate procedures and expert assistance were used.[92] However, the business judgment rule applies to a determination of the circumstances under which an officer or director may be liable for the adverse consequences of his or her conduct, but does not address whether such conduct was in the public interest.[93] "While the business judgment rule reflects a judicial policy of declining to substitute a court's judgment for that of a corporation's directors . . ., that policy has no application to allegations that a public benefit corporation has abandoned any charitable purpose and has pursued private, rather than public, interests."[94] Similarly, while courts typically do not interfere with internal corporate matters, that policy is inapplicable when "the legislature has specifically given the Attorney General and the courts authority and responsibility to ensure that nonprofit public benefit corporations operate in the public

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[87] *Merriam Webster's Collegiate Dictionary* 417 (10th ed. 1994) (discussing synonyms under definition of "fair").

[88] *Id.* (emphasis added).

[89] *Id.* at 974.

[90] *Black's Law Dictionary* 1244 (7th ed. 1999).

[91] *See* WASH. REV. CODE ANN. § 48.31C.030(5)(a)(ii)(C)(II); *see also* WASH. REV. CODE ANN. § 48.31B.015(4)(a)(iv).

[92] *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (stating "[a] hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose'") (citing *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)); *see also Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (discussing the limits to the protection afforded management by the business judgment rule).

[93] *See Summers v. Cherokee Children & Family Servs., Inc.*, 112 S.W.3d 486, 529 (Tenn. Ct. App. 2002).

[94] *Id.*

interest and not for private gain."[95] For example, Tennessee's public policy, as expressed by the legislature, is that intervention in these situations is appropriate because "the public interest is involved and the activities involved are not merely 'internal corporate matters.'"[96] Additionally, in a nonprofit corporate context, several courts have indicated that "'the modern trend is to apply corporate, rather than trust principles, in determining the liability of the directors of charitable corporations because their functions are virtually indistinguishable from those of their "pure" corporate counterparts.'"[97] Although a nonprofit board is governed generally by corporate law principles, if a nonprofit corporation's nonprofit purpose or structure will be significantly altered, then that decision seems to be governed by a stricter charitable trust law standard.[98] A charitable corporation has the power to amend purposes to the extent that the new purposes are not inconsistent with the corporation's original purpose.[99] "The line of demarcation at which point the courts will interfere with the discretion of those governing a public charity reasonably is the point of substantial departure by the governors (or Board) from the dominant purpose of the charity. . . ."[100] Clearly, the Transaction would mark a significant departure from PREMERA's historical structure and public benefit purpose. Similarly, in the attempted conversion of the Kansas BCBS plan, the Kansas Supreme Court noted that although the Insurance Commissioner could not "get involved in the board's management decisions" she could "deny an acquisition based on their management decisions because of her authority pursuant to the acquisition statute, *e.g.*, when it is not in the public interest."[101]

While Washington law does not promulgate a test for whether the Transaction is unfair and unreasonable to subscribers or policyholders, and not in the public interest, the ordinary meaning of those terms, along with the foregoing policy considerations in protecting the public, require an analysis of PREMERA's substantive decisions. As a practical matter, the Commissioner must

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[95] *Id.* at 529–30.

[96] *Id.* at 530.

[97] *O'Donnell v. Sardegna*, 646 A.2d 398, 408 (Md. 1994) (citing *Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1013 (D.D.C. 1974)); *see also Blue Cross & Blue Shield of Mich. v. Baerwaldt*, 361 N.W.2d 742, 748 (Mich. Ct. App. 1984) (holding that the Insurance Commissioner could not merely substitute her judgment for that of a Blues plan's board of directors but rather, under the applicable statute, could only disapprove rates which were "unfair or unreasonable")..

[98] Robert A. Boisture & Douglas N. Varley, *State Attorneys General's Legal Authority to Police the Sale of Nonprofit Hospitals and HMOs*, 13 EXEMPT ORG. TAX REV. 227, 228 (1996) ("While charitable corporations are not treated as trusts for all purposes, courts and commentators have taken the position that the assets of a charitable corporation are impressed with a charitable trust limiting the purposes for which they can be used to the purposes of the corporation as those purposes were defined at the time the assets were given.").

[99] *See Attorney Gen. v. Hahnemann Hosp.*, 494 N.E.2d 1011, 1020–21 (Mass. 1986) (stating that the new charitable purposes must be "similar and not contradictory" to the old charitable purposes, to protect the public from having the funds applied to any charitable purpose).

[100] *Taylor v. Baldwin*, 247 S.W.2d 741, 750 (Mo. 1952).

[101] *Blue Cross & Blue Shield of Kan., Inc.*, 75 P.3d 226, 240–41 (2003).

balance the Transaction's anticipated benefits against its expected adverse consequences for policyholders, subscribers, and the public. As part of this analysis, the Commissioner should certainly consider PREMERA's arguments in support of the Amended Transaction, as well as contrary submissions by other parties.

b. Comparison of Public Interest Under the Holding Company Acts to Statutory Requirements and Policy Concerns of Acquisitions of Nonprofit Hospitals in Washington

In addition to the ordinary meaning of "public interest;" the Commissioner may, under the statutory construction principle of *in pari materia*, look to any other Washington statutes that relate to the same subject matter and are not inconsistent with the Holding Company Acts.[102] Arguably, WASH. REV. CODE ANN. Chapter 70.45 ("Acquisition of Nonprofit Hospitals"), which sets forth requirements applicable to a nonprofit hospital's conversion, relates to the same subject matter as the Holding Company Acts. WASH. REV. CODE ANN. Chapter 70.45 expresses the public interest as follows:

> The health of the people of our state is a most important public concern. The state has an interest in assuring the continued existence of accessible, affordable health care facilities that are responsive to the needs of the communities in which they exist. The state also has a responsibility to protect the public interest in nonprofit hospitals. . . .[103]

In light of the foregoing expression of the public interest, the legislature has given content to the meaning of "the public interest," by requiring that an acquisition of a nonprofit hospital by a for-profit entity not be approved unless there is a determination that, *inter alia*:

> (1) Sufficient safeguards are included to assure the affected community continued access to affordable care, and that alternative sources of care are available in the community should the acquisition result in a reduction or elimination of particular health services; [and] . . . (4) [t]he acquiring person and parties to the acquisition are committed to providing health care to the disadvantaged, the uninsured, and the underinsured and to providing benefits to promote improved health in the affected community. Activities and funding provided under WASH. REV. CODE ANN. 70.45.070(8) [*i.e.*, the statute requiring that the value of a nonprofit hospital's

[102] *See Hallauer v. Spectrum Props., Inc.*, 143 Wash. 2d 126, 146, 18 P.3d 540, 550 (2001) (holding that where statutes relate to the same subject matter, they are "'to be read together as constituting a unified whole, to the end that a harmonious, total statutory scheme evolves which maintains the integrity of the respective statutes'") (citing *State v. Wright*, 84 Wash. 2d 645, 650, 529 P.2d 453, 457 (1974)).

[103] WASH. REV. CODE ANN. 70.45.010.

> charitable assets be safeguarded and used for appropriate charitable health purposes] may be considered in evaluating compliance with this commitment.[104]

It may be argued that the subject matter of WASH. REV. CODE ANN. Chapter 70.45 is not sufficiently related to the Amended Transaction to warrant its application under the doctrine of *in pari materia*. But, to the extent that both matters concern nonprofit health care entity conversions, the doctrine may indeed be applicable. Moreover, whether or not applicable under the doctrine of *in pari materia*, the statute does articulate an important public policy of the State of Washington. Because the health of the people of Washington is a most important public concern, the state, acting in *parens patriae* through its agent, the Commissioner, has an interest in assuring the continued availability of accessible and affordable health insurance. Much as in the nonprofit hospital context, the public interest (including the interests of subscribers and policyholders), which the Commissioner should determine are not impacted adversely, includes, *inter alia*, the following: (1) whether affordable health insurance is accessible, (2) whether alternative sources of affordable health insurance are available in the community if there is a reduction or elimination of any particular health insurance offerings, (3) whether health insurance will be provided to the disadvantaged, the uninsured, and the underinsured, and (4) whether benefits will be provided to promote improved health in the affected community.

c. Availability of Accessible, Affordable Health Insurance

The Commissioner must consider the Transaction's likely effect on the availability of accessible, affordable health insurance to determine whether the Transaction is unfair and unreasonable to subscribers or policyholders, and not in the public interest.[105] This consideration entails at least two distinct, but closely related, elements: (1) the extent to which PREMERA's products will result in a negative financial impact for subscribers or policyholders as a result of the Transaction, and (2) the extent to which, as a result of the Amended Transaction, New PREMERA will reduce or change the products it offers, particularly in impaired markets. PwC's reports will focus extensively on these issues.

(1) Negative Financial Impact for Subscribers or Policyholders

As discussed more fully in C&B's Final Report, if PREMERA becomes a for-profit company, it may experience shareholder pressure that would not have not existed had PREMERA remained a nonprofit company. Shareholders could pressure New PREMERA to increase profitability in order to increase share value. The increase in profitability, specifically, operating margins, logically, can occur in only two ways: increase revenues or reduce expenses. The pressures to increase revenues may result in an increase in premiums, generally, or an increase of relatively more profitable business (or, conversely, reduce the amount of business that is unprofitable, or relatively less profitable). Clearly, either measure can have materially adverse

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[104] WASH. REV. CODE ANN. 70.45.080(1), (4).

[105] *Cf.* WASH. REV. CODE ANN. 70.45.010 (explaining that the state not only has an interest in accessible, affordable health care facilities, but also a "responsibility to protect the public interest in nonprofit hospitals").

Proprietary Material Redacted

consequences for subscribers, policyholders, and the public. Premium rate increases would most likely be targeted at areas in which PREMERA has market power such as eastern Washington, and more specifically to those lines of business in which it is easier to manipulate premiums such as the individual and regulated small group product lines in eastern Washington. For individual business, PREMERA will need to increase operating margins to approximately 20% for those counties in which it has market power to reach its target operating margin of approximately [ ][106] For regulated small group business, PREMERA will need an operating margin of approximately 10% to meet its target operating margin of approximately [ ][107] This results in premium rates of over $300 per person per month for members in these lines of business by 2007.[108] Over the projected period, PwC's model indicates that the members in the individual line of business would pay [ ] to [ ] more than expected medical trends, and members in the regulated small group business would pay [ ] more than expected medical trends.[109] These increases would be limited to members in counties where PREMERA has market power.[110] The total number of members in the individual and small group markets would be between 97,000 to 98,000, or approximately 17% of projected enrollment.[111] On the other hand, rather than achieving these levels by using only premium increases, PREMERA could potentially lower provider payments to partially offset necessary premium increases.[112] An alternative scenario presented by PwC shows that premiums for individual business would increase by [ ] over expected medical trend, and premium increases for the regulated small group business line would increase between [ ] to [ ] above expected medical trend if provider payment rates were decreased by [ ] of the health care cost trend.[113] Moreover, if PREMERA were to experience "a material change in structure" for purposes of I.R.C. § 833(c)(2)(C), then the higher effective corporate tax rate of 35% would require additional increases to offset the lower post-tax operating gain.[114] A discussion of the potential tax implications can be found *supra* at section III.D.1. Alternatively, PREMERA could decrease unprofitable business by exiting unprofitable markets and product lines. Obviously, if PREMERA exited such markets or

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[106] PwC, Economic Impact Analysis of the Proposed Conversion of PBC, at 92 (Oct. 27, 2003) (on file with C&B).

[107] *Id.*

[108] *Id.*

[109] *Id.* at 97.

[110] *Id.*

[111] *Id.*

[112] *Id.*

[113] *Id.* at 98.

[114] *Id.* at 123.

product lines, then those subscribers and policyholders would be affected adversely as described *infra* at section III.D.2.c.(2).[115]

Secondly, reducing expenses can also generally be accomplished in two ways: reducing sales, general, and administrative ("SG&A") expenses, and/or reducing claims expenses.[116] It is not unreasonable to conclude that New PREMERA will be pressured to reduce its SG&A expenses. Arguably, reducing SG&A expenses can be accomplished without adverse consequences to subscribers, policyholders, and the public. There is no evidence that PREMERA would generate greater administrative efficiencies with additional capital than it would without additional capital. Contrary to the foregoing stated uses, PREMERA has also suggested that the additional capital could be used for technological capital expenditures. However, as will be shown *infra* at section III.D.2.d, this suggestion should not be given much weight. Conversely, reducing SG&A expenses might have a materially adverse effect on subscribers, policyholders, and the public, because New PREMERA might reduce SG&A expenses simply by reducing the quantity or quality of services to claimants and members.

With respect to the reduction of claims expenses, New PREMERA might enter into more favorable agreements with health care providers, thereby reducing the cost of care (and, therefore, claims expense) without an adverse impact on subscribers, policyholders, and the public. But the obverse is also true, in that reducing the cost of care might have materially adverse effects on subscribers, policyholders, and the public. For example, PREMERA may reduce claims expense by paying fewer claims (*i.e.*, reducing the scope of coverage or "rationing" care more aggressively). Moreover, New PREMERA might seek a reduction in provider compensation agreements, which may not negatively affect subscriber or policyholder premiums, but may cause an exit of providers from the Washington market, thereby reducing the quality or quantity of care.

PREMERA may argue that its projections and targets were developed irrespective of PREMERA's corporate structure. But, as has been described above, as a nonprofit company, if PREMERA falls short of investor expectations, there is no shareholder pressure compelling management to achieve those expectations. In the past, although PREMERA has improved its profitability, it still has fallen short of target expectations. Yet, rather than trying to take advantage of certain markets, such as eastern Washington, where there is less price (premium) competition, or where it could potentially raise premiums above competitive levels due to market power, PREMERA has maintained the status quo. Presumably, with shareholder pressure for increased returns or achievement of certain targets, combined with stock options tied to New PREMERA's share price, management will probably not sit by idly and forego these opportunities in the future. As the Supreme Court of Kansas analogized with respect to the Kansas BCBS conversion, "the

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[115] Although this method of improvement actually decreases revenues, it does increase the overall operating margin.

[116] Blackstone Valuation and Fairness Report, *supra* note 81, at 43; PBC, Performance and Outlook Meeting: Being a Public Company, at 0017127 (Sept. 25, 2002) (on file with C&B) (stating that the median SG&A expenses for comparable companies was 14.5%).

Commissioner is not required to wait until likely future harm to the public appears before locking the barn door; she may do so now as a preventative."[117]

However, the Commissioner in determining whether he has sufficient evidence on the record to disapprove the Amended Transaction should take into account certain assurances provided by PREMERA. PwC has indicated that these assurances diminish the concern that PREMERA will have the ability to manipulate premium rates of regulated individual and small group markets by geography such as in eastern Washington. In addition, "PREMERA has provided certain assurances with respect to providers in the form of assuring that New PREMERA will maintain or offer a network for a statewide PPO product that meets or exceeds the network adequacy standards developed by PREMERA. . . ." PwC again notes that this assurance mitigates, to some degree, its concern that the Amended Transaction will result in an inadequate provider network. PwC does, however, note that both these assurances are deficient in one material respect. These assurances are for a period of only two years following the effective date of the Amended Transaction. PwC has indicated that even if these assurances substantively are reasonable, they should be effective for at least three years. But, it should be noted that regardless of the duration of PREMERA's assurances, they are temporary mechanisms only and the concerns raised by PwC will still exist, though perhaps not until at some point after the assurances expire. Thus, the Commissioner should weigh all the foregoing factors in determining whether the concerns raised by PwC are offset sufficiently to permit the Amended Transaction to be approved. If the Commissioner were to approve the Transaction, then he should consider whether the assurances for a term of less than three years are appropriate.

(2) Effect on the Uninsured and Underinsured

Related to the accessibility, affordability, and availability of insurance are the issues of whether the Amended Transaction will have an effect upon the extent to which the disadvantaged, the uninsured, and the underinsured, will have access to health insurance, and whether benefits will be provided to promote improved health in the affected community.[118] Arguably, PREMERA has no independent obligation to assure the adequacy of available coverages for these impaired populations. But, to the extent that the Amended Transaction may have an adverse effect on such availability, it is important to ascertain whether the Transaction will produce salutary balancing effects. This involves a determination of whether PREMERA's offering of products designed to appeal to the uninsured and underinsured, together with the activities that can reasonably be expected from the consideration to be realized by the Washington Foundation, can adequately make health insurance accessible to Washington's most vulnerable citizens.

As shown by PwC, PREMERA will have the ability to increase premiums to achieve target returns. Assuming that PREMERA does indeed raise premiums due to shareholder pressures, PwC's

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[117] *Blue Cross & Blue Shield of Kan., Inc.*, 75 P.3d 226, 245 (2003).

[118] *Cf.* WASH. REV. CODE ANN. 70.45.080(4) (requiring the acquirer be "committed to providing health care to the disadvantaged, the uninsured, and the underinsured and to provid[e] benefits to promote improved health in the affected community" before the department of health will approve the sale of a nonprofit hospital).

model also shows that certain members will most probably be compelled to drop coverage, or new enrollment may decline. These consequences as a result of the Amended Transaction may cause an increase in the uninsured population or reduce access to health insurance in the communities where PREMERA has market power. However, as discussed previously, PwC has also indicated that certain assurances that PREMERA has provided with respect to the manner in which it determines rates will mitigate potential premium increase. But, again, these assurances are only for two years as opposed to the minimum of three years that PwC believes is needed.

Conversely, in areas such as rural eastern Washington, where PREMERA is functionally a single player, a particular concern is whether New PREMERA may leave the market if it cannot realize a sufficient return on investment. PREMERA asserts that it currently bases its business decisions on the profitability of various markets, and not on other intangible nonprofit motives. Specifically, in its meeting with the Consultants on November 26, 2002, management asserted that PREMERA does not remain in unprofitable markets, as that would result in "cross-subsidization" (whereby some policyholders would, in effect, pay higher premiums to support lower premiums in unprofitable markets).[119] Historically, PREMERA has not fully exited unprofitable markets, though it may have reduced its writings in some cases. With the need to respond to investor expectations, PREMERA may feel compelled to discontinue unprofitable lines of business quickly and fully. The Commissioner may consider this as an additional factor in deciding whether to approve the Amended Transaction.

d. PREMERA's Arguments in Favor of the Amended Transaction

As discussed *supra* at section III.D.2.a, the Commissioner may elect to balance the negative consequences expected to be produced by the Transaction against its anticipated positive effects. PREMERA's primary argument in favor of the Amended Transaction is that it will generate additional capital and thereby increase its RBC ratio. As discussed in C&B's Final Report, access to the equity markets may not actually be indispensable. But, <u>some</u> additional capital may benefit PREMERA by allowing greater flexibility in the future with respect to strategic decisions. Assuming *arguendo* that additional capital is needed, the question remains as to whether those needs can be satisfied by some other alternative. If additional capital to meet PREMERA's supposed needs reasonably can be obtained through some other mechanism, then it follows that less weight should be given to PREMERA's implication that it needs to become a for-profit company in order to access additional capital. Blackstone notes that there were alternatives that could have satisfied

[119] Even if cross-subsidization is impermissible in the context of utility rates, the concept is inapplicable in the context of insurance rates. *Blue Cross & Blue Shield of Mich. v. Baerwaldt*, 361 N.W.2d 742, 748 (Mich. Ct. App. 1984) (criticizing *Blue Cross of Kan., Inc. v. Bell*, 607 P.2d 498 (Kan. 1980), which indicates the contrary). The principle that each class of customers must pay its own way, and that cross-subsidization of classes is unfair and unreasonable, is drawn from public utility cases, where most rates are based upon what a customer uses, no element of risk-sharing is involved, and it is easy to conclude that subsidies between classes of customers are unfair. *Baerwaldt*, 361 N.W.2d at 748. The situation is different in the business of insurance, which "necessarily involves a far more imperfect assessment of the cost of benefits provided." *Id.* Even if the proposition in *Bell* is valid in Washington, the Supreme Court of Kansas has distinguished the factual situation in its decision in *Bell* from a situation involving an acquisition. *Blue Cross & Blue Shield of Kan., Inc.*, 75 P.3d at 240–41.

PREMERA's alleged capital requirements.[120] These same alternatives have been considered by PREMERA as discussed more fully in C&B's Final Report. Furthermore, other factors may have contributed to management's decisions, such as the "momentum of Blues conversions"[121] and "political matters,"[122] as opposed to substantive business needs. Additionally, PREMERA has not articulated specifically the technological expenditures it requires, although it suggests that the additional capital will be used for such expenditures, presumably to reduce SG&A expenses as discussed more fully in C&B's Final Report.[123]

In sum, a reasonably compelling business necessity for PREMERA to convert in order to access the equity markets does not seem apparent, although some additional capital may provide greater financial flexibility. Of course, the Transaction should not be disapproved merely because it has not been shown to be necessary for PREMERA's survival. However, assuming that the Commissioner finds that the Transaction produces negative effects to subscribers, policyholders, providers, or the public, and those effects have not been sufficiently mitigated, then the Transaction should be approved only upon the satisfaction of appropriate conditions or disapproved completely, unless PREMERA demonstrates other countervailing positive effects.

In addition to its arguments that the Transaction will benefit the company, PREMERA also suggests that the Washington Foundation will provide benefits to offset any negative effects of the Transaction. With respect to the Amended Transaction, PREMERA has not demonstrated that the purposes and benefits of the Washington Foundation will offset such negative effects. The Commissioner, therefore, should not give significant weight to PREMERA's implication that the purported benefits of the Washington Foundation will offset the negative impact of the conversion.

e. Conflicts of Interest

The public interest also precludes the Commissioner from approving the Transaction unless he determines that no conflicts of interest exist related to the Amended Transaction, including, but not limited to, conflicts of interest related to PREMERA's directors, officers, or experts.[124] These potential conflicts are discussed *infra* at section IV.A.

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[120] Blackstone Valuation and Fairness Report, *supra* note 81, at 7.

[121] PREMERA, Board Retreat: Capital Planning Options, at 0016922 (Sept. 9, 2001) (on file with C&B); PBC, Officer Meeting, at 0017023 (May 28, 2002) (on file with C&B) [BOTH CONFIDENTIAL].

[122] *Id.*

[123] Plan of Conversion of PREMERA, PBC, and LifeWise of Washington, Form A: Exhibit A-4, art. II, at 5 (Sept. 26, 2002), *available at* http://www.insurance.wa.gov/special/premera/filing/ExhibitA-4.pdf [hereinafter "Plan of Conversion, Form A: Exhibit A-4"].

[124] *Cf.* WASH. REV. CODE ANN. 70.45.070(4) (providing that an acquisition of a nonprofit hospital by a for-profit entity may not be approved unless "[n]o conflict of interest exists related to the acquisition, including, but not limited to, conflicts of interest related to board members of, executives of, and experts retained by, the nonprofit corporation, acquiring person, or other parties to the acquisition").

f. Fair Market Value

Apart from the concerns already discussed, the public interest requires that the Washington Foundation receive its share of PREMERA's fair market value, and that the Washington Foundation's ability to realize that fair market value in cash not be placed at unreasonable risk by the manner in which the Amended Transaction is structured.[125] The need to transfer its fair market value, as opposed to some other valuation standard, has been recognized implicitly by PREMERA for a number of reasons. PREMERA has stated throughout this process that although it does not consider itself a charitable organization,

> practically speaking this doesn't matter [, because they] are nevertheless proposing to grant all the initial stock in the new company—in other words, the entire value at the time of the conversion—to a foundation that can sell that stock over time to fund health initiatives in Washington and Alaska.[126]

However, the "entire value" clearly would not be transferred if the Foundations received less than PREMERA's fair market value. In that case, only a portion of the "entire value" will have been transferred. Assuming *arguendo* that the transfer of the "entire value" does not necessarily equate to the transfer of fair market value, PREMERA implies that fair market value would be the standard by which to determine whether PREMERA's value has been transferred to the Foundations if PREMERA were indeed a charitable corporation. PREMERA's assertions that it is not a charitable corporation seem contrary to the actions taken by PREMERA's directors and management. The question arises as to why PREMERA would entertain the notion that PREMERA's value, fair market or otherwise, should be transferred to another entity. If PREMERA is a charitable organization, then this conveyance is understandable. If PREMERA is not a charitable organization, then this conveyance is not only puzzling, but should be considered a breach of the board's and management's fiduciary duty to the owners of the company. That is, conveying to the Foundations the value of a company worth hundreds of millions of dollars when there is no legal requisite to do so, assuming that PREMERA's assertion that it is not charitable is accurate, cannot be deemed anything but a breach of fiduciary duty. But, of course, PREMERA has not (and indeed could not) identify any other "owners" of the company. It is, in the final analysis, a public asset, for the sale of which the public must be compensated fully. PREMERA's management and directors, thus, must either accept the notion, which C&B believes is accurate, that PREMERA is a charitable corporation obligated to transfer its fair market value, or in the alternative, it should be subject to legal consequences stemming from the knowing breach of its fiduciary duty. More detailed analysis regarding the specifics of the Amended Transaction's transfer of fair market value will be provided in sections related to Stage Two, *infra* at section IV.C.

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[125] *Cf.* WASH. REV. CODE ANN. 70.45.070(5), (6) (providing that an acquisition of a nonprofit hospital by a for-profit entity may not be approved unless "[t]he nonprofit corporation will receive fair market value for its assets" and "[c]haritable funds will not be placed at unreasonable risk, if the acquisition is financed in part by the nonprofit corporation").

[126] PREMERA, Management Meeting, at 0010200 (providing various talking points about the conversion in response to questions about the conversion) (on file with C&B).

3. Management's Competence, Experience, and Integrity

With respect to the fifth potentially disqualifying fact, the Commissioner must determine whether the competence, experience, and integrity of those persons who would control PREMERA is such that it would not be in the subscribers' or the policyholders' interest, and not in the public interest, to permit the acquisition of control.[127] PREMERA's management and New PREMERA's management will be the same prior to, and after, the Amended Transaction. Thus, the Transaction should not affect management's competence, experience, and integrity. However, the Transaction itself may be motivated by other factors (*e.g.*, expectations of stock options, increased salary, or other compensation as a result of the proposed conversion to for-profit status), and thus, may affect negatively management's incentives. PREMERA has provided its executive compensation plan which describes the compensation that management will, or may, receive: (1) once the Amended Transaction is complete, (2) at the time of an IPO, and (3) in future years. Moreover, PREMERA has provided certain assurances with respect to executive compensations. The executive compensation plan and assurances are analyzed in greater detail *infra* at section IV.A, as part of Stage Two.

4. Hazardous or Prejudicial to the Insurance-Buying Public

With respect to the sixth potentially disqualifying fact, the Commissioner must determine whether the Transaction is likely to be hazardous or prejudicial to the insurance-buying public.[128] There are a variety of ways in which the conversion might be hazardous or prejudicial to the insurance-buying public. For example, this would be the case if PREMERA's financial condition, surplus levels, or other indicators of ability to satisfy policyholder claims would be weakened. Because the conversion is simply a series of transactions whereby nonprofit companies will convert to for-profit companies, PREMERA's financial condition, prior to, and after the conversion, should be the same from an operating standpoint, except to the extent of transaction costs not expected to have a material adverse effect. The Amended Transaction might also cause material adverse tax consequences. PREMERA has not been exempt from federal income tax since 1987, and has never been exempt from Washington's state taxes. However, as discussed *supra* at section III.D.1, increases in Alaska premium taxes, and the loss of benefits under I.R.C. § 833(b), could impact PREMERA's financial condition materially. In order to compensate for these effects, if they occur, PREMERA may need to raise premium rates. On the other hand, PREMERA has provided certain assurances with respect to increases in Alaska' premium taxes for a period of two years. In addition, as discussed *supra* at section III.D.2.c.(1), the Transaction might induce PREMERA to increase premiums, reduce provider compensation, or otherwise alter its practices adversely to policyholders or health care providers. These areas are the subject of PwC's analysis, which concludes that such adverse effects are possible but not predictable. PwC has also indicated that certain assurances provided by PREMERA do mitigate the foregoing possibilities to some degree, but only for a period

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127 WASH. REV. CODE ANN. § 48.31C.030(5)(a)(ii)(C)(III); *see also* WASH. REV. CODE ANN. § 48.31B.015(4)(a)(v).

128 WASH. REV. CODE ANN. § 48.31C.030(5)(a)(ii)(C)(IV); *see also* WASH. REV. CODE ANN. § 48.31B.015(4)(a)(vi).

of two years. As noted earlier, PwC believes that these assurances should be provided for a term of not less than three years. Furthermore, the analyses of the actuarial, accounting, and tax Consultants could disclose other potential hazards or prejudices to the insurance-buying public that, although not obvious, might nonetheless result from the Transaction.

IV. STAGE TWO

As the Original Engagement was structured, prior to commencement of this evaluation, areas of analysis were segregated between two hypothetical phases, Stage One and Stage Two. As the review of the Original Transaction evolved, the distinctions between Stage One and Stage Two were found to be less meaningful, and a substantial portion of the second phase issues were analyzed along with those in the first phase. These have been discussed at some length in the preceding sections of this Supplemental Report together with the more in-depth analysis in C&B's Final Report. As in the Final Report, a few Stage Two matters in this Supplemental Report, however, have not received as much attention.

Under the Holding Company Acts, the Commissioner is required to approve the Transaction unless he makes one of the following fact-findings: (1) after the change of control, the domestic health carrier would not be able to satisfy a domestic health carrier's registration requirements, (2) there is substantial evidence that the acquisition would substantially lessen competition or tend to create a monopoly in insurance in Washington, (3) the acquiring party's financial condition is such as might jeopardize the health carrier's financial stability or prejudice its subscribers' interest, (4) the plans or proposals that the acquiring party has to liquidate the health carrier, sell its assets, consolidate or merge it with any person, or to make any other material change in its business or corporate structure or management are unfair and unreasonable to the health carrier's subscribers, and not in the public interest, (5) the competence, experience, and integrity of those persons who would control the health carrier's operations are such that it would not be in the interest of the health carrier's subscribers, and of the public, to permit the acquisition of control, or (6) the acquisition is likely to be hazardous or prejudicial to the insurance-buying public.[129]

Each of the foregoing potential fact-findings that the Commissioner is required to make in his determination of whether to approve the Transaction has been considered previously in C&B's Analysis. This section IV is an analysis of the additional Stage Two issues that are evaluated as part of this Supplemental Report. They are as follows: (1) conversion-related self-dealing and conflicts of interest of PREMERA's officers and trustees, (2) independence of the Washington Foundation from PREMERA, and (3) the stock transfer documents and the transfer of PREMERA's fair market value.

A. Self-dealing and Conflicts of Interest for PREMERA's Officers and Trustees

Generally a company's officers and directors cannot engage in self-dealing, and there should be no conflicts of interests in making business decisions. Moreover, under the fairness and

[129] *See supra* note 41 and accompanying text.

reasonableness requirements of the Holding Company Acts, as discussed *supra* at section III.D.2.e, self-dealing or conflicts of interest in the formulation of the Amended Transaction or of PREMERA's management would undermine the public interest. In addition, self-dealing or conflicts of interest could affect management's integrity adversely, which itself would be a basis for disapproval under the fifth criteria of the Holding Company Acts. Thus, the Commissioner might be compelled on several grounds to disapprove the conversion if he finds that management engaged in self-dealing or that a conflict of interest existed.

This analysis delves into conflicts of interest that can be both facially determined, as well as those that might be inferred circumstantially. The very nature of this analysis involves determination as to whether management's stated reasons for conversion comport with the available facts. One of the purported benefits of the Transaction articulated by PREMERA was improved retention of management due to increased career growth opportunities and long-term incentives.[130] But, PREMERA acknowledged that it has "one of the most experienced management teams in the industry," which has "worked together for [five] years," and "[s]uccessfully executed PREMERA's turnaround plan."[131] Furthermore, PREMERA noted that, according to a recent survey, it is a "Preferred Employer."[132] PwC's executive compensation experts have determined that company-wide and management retention have not been a problem in the past. Overall, PwC believes that PREMERA's voluntary termination turnover rate for management is lower than that of industry comparable data. Certainly, the consideration of management retention in determining whether to convert, if there was no apparent need, suggests the possibility of a conflict of interest. This could be perceived as a conflict of interest because management's true motivation might have been its own enrichment. Such an inference is based on more than mere baseless speculation. A presentation to the board stated that "career growth opportunities" and "long-term incentive" were advantages of being a for-profit company.[133] Perhaps these are advantages for management, but they may not be advantages for PREMERA's policyholders and insureds. On this record, the Commissioner would be justified in concluding that improved compensation for management was a material motivator for the Amended Transaction without demonstrated benefits for PREMERA's policyholders or the public. In the absence of other sufficiently persuasive rationale for the conversion, its anticipated economic benefits for management cannot be ignored. The underlying potential conflict is a factor that the Commissioner is quite justified in considering when evaluating whether to approve the Transaction. In that analysis, the record before the Commissioner provides thin support for management's assertion that the Transaction will improve management retention.

Additionally, the amount of compensation that management receives should be subject to the non-inurement restrictions on nonprofit corporations. A Chapter 24.03 WASH. REV. CODE ANN. nonprofit corporation, such as PBC, may pay compensation in a reasonable amount to its members,

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130 PREMERA, Board Retreat: Capital Planning Options, at 0016918, 0016921 (Sept. 9, 2001) (on file with C&B).

131 Goldman, PBC: Mock Presentation to Investors, at 0017337 (Oct. 6, 2002) (on file with C&B).

132 PREMERA, Board of Directors Minutes at 0035582 (Feb. 11–12, 2003) (on file with C&B).

133 Capital Planning Options Board Retreat, at 0037043 (Sept. 9, 2001) (on file with C&B).

directors, or officers for services rendered,[134] but may not make any distribution of income to such persons.[135] A Chapter 24.06 WASH. REV. CODE ANN. nonprofit corporation, such as PREMERA, may fix compensation for its officers and agents,[136] and although not expressly stated in Chapter 24.06 WASH. REV. CODE ANN., PREMERA's nonprofit nature necessarily implies that the corporation may not otherwise distribute corporate income or profits to officers or directors.[137] The rationale behind the non-inurement restriction on nonprofit corporations has been explained as follows:

> Why do nonprofits operate under a non-distribution constraint that prohibits those who control nonprofits from benefitting from or distributing earnings? Bound by their promise to use their resources to advance their missions rather than benefit private parties, nonprofit organizations emerge as a solution to what Hansmann called "contract failure." People seek out nonprofits in areas where they cannot penetrate and police services using ordinary contractual devices, in situations where trust and information are scarce, and assessing the value of the services they receive for their money is difficult. The legally binding non-distribution constraint of nonprofit organizations provides a powerful contractual assurance that the consumer will not be taken advantage of or betrayed by producers for personal gains. The fact that profits are not allowed to be distributed to shareholders or owners gives the consumer of services a certain confidence that the transaction will result in a fair exchange.
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> . . . .
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> Hansmann's central argument is consistent. We can understand the emergence of the nonprofit sector by looking at the unsatisfied demand for certain kinds of goods. Contract failure opens a door through which the nonprofit sector can move and capitalize on some of the shortcomings of for-profit firms. For Hansmann, the appearance and continued survival of nonprofit activity in a broad array of fields ultimately comes down to the ability of these organizations to satisfy an unmet demand by inspiring trust.[138]

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[134] WASH. REV. CODE ANN. 24.03.030(4).

[135] WASH. REV. CODE ANN. 24.03.030(2); *see* WASH. REV. CODE ANN. 24.03.005(3) (defining a "nonprofit corporation" as "a corporation no part of the income of which is distributable to its members, directors or officers").

[136] WASH. REV. CODE ANN. 24.06.030(11).

[137] *Cf. Sound Health Ass'n v. Comm'r*, 71 T.C. 158, 159 (1978) ("As a nonprofit corporation, the petitioner cannot, by Washington law, be operated for the personal benefit of any member, officer, or director.").

[138] Peter Frumkin & Alice Andre-Clark, *Nonprofit Compensation and the Market*, 21 U. HAW. L. REV. 425, 465–67 (1999) [hereinafter Frumkin & Andre-Clark].

Washington courts do not appear to have elaborated upon the limits on compensation paid by nonprofit corporations; however, the I.R.C. and cases construing it provide some guidance. For example, organizations may be exempt from federal income taxation under I.R.C. §§ 501(c)(3) and 501(c)(4) only so long as no part of their net earnings inure to the benefit of any private shareholder or individual. By further example, pursuant to I.R.C. § 833(c)(3)(A)(vi), a non-BCBS health insurance plan may receive the same favorable tax treatment as BCBS plans if, *inter alia*, "no part of its net earnings inures to the benefit of any private shareholder or individual."[139] The purpose of the non-inurement restriction is to stay the hands of those who are in a position to siphon off the organization's funds for their own benefit.[140] When the nonprofit organization's purposes are sacrificed to the private interests of those in control, the organization is made to serve a private interest.[141] For purposes of these I.R.C. restrictions, compensation constitutes prohibited inurement of a private benefit if the compensation is "unreasonable."[142]

Whether compensation paid by a nonprofit corporation is reasonable or excessive may be determined by reference to criteria similar to those which apply in determining whether compensation paid by a for-profit organization is deductible under I.R.C. § 162.[143] In the context of for-profit corporations, compensation in excess of reasonable compensation for services rendered is subject to disfavored tax treatment; the excess above reasonable compensation being treated as a nondeductible dividend distribution rather than a deductible expense under I.R.C. § 162.[144] The reasonableness of compensation is a question of fact.[145] Factors considered by the courts in determining whether compensation is reasonable in the for-profit context of § 162 include: (a) the employee's qualifications, (b) the nature, extent, and scope of the employee's work, including positions held, hours worked, and duties performed, (c) the size and complexities of the employer's business, as indicated by its sales, net income, or capital value, (d) a comparison of salaries paid with the employer's gross and net income,[146] (e) the prevailing general economic conditions, (f) a

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[139] I.R.C. § 833(c)(3)(A)(vi).

[140] *United Cancer Council, Inc. v. Comm'r*, 165 F.3d 1173, 1176 (7th Cir. 1999).

[141] *Sound Health Ass'n*, 71 T.C. at 186.

[142] *See, e.g.*, *Bubbling Well Church of Universal Love v. Comm'r*, 670 F.2d 104, 105 (9th Cir. 1981); *Mabee Petroleum Corp. v. United States*, 203 F.2d 872, 876 (5th Cir. 1953).

[143] *Alive Fellowship of Harmonious Living v. Comm'r*, 47 T.C.M. (CCH) 1134 (1984) (no page numbers available).

[144] *See, e.g.*, *Elliotts, Inc. v. Comm'r*, 716 F.2d 1241, 1242 (9th Cir. 1983); *B & D Founds., Inc.*, 82 T.C.M. (CCH) 692 (2001); *Labelgraphics, Inc.*, 76 T.C.M. (CCH) 518 (1998); *Mad Auto Wrecking, Inc.*, 69 T.C.M. (CCH) 2330 (1995).

[145] *B & D Founds.*, 82 T.C.M. (CCH) 692 (2001); *Labelgraphics, Inc.*, 76 T.C.M. (CCH) 518 (1998); *Mad Auto Wrecking, Inc.*, 69 T.C.M. (CCH) 2330 (1995).

[146] Net income is usually more important, because it more accurately gauges whether a corporation is disguising the distribution of dividends as compensation. *B & D Founds., Inc.*, 82 T.C.M. (CCH) 692 (2001). No particular ratio between compensation and gross or net taxable income is a prerequisite for a finding of reasonableness. *Id.*

comparison of salaries with distributions to shareholders and retained earnings, (g) the prevailing rates of compensation for comparable positions in comparable concerns,[147] (h) the salary policy of the employer as to all employees, (i) the amount of compensation paid to the particular employee in previous years,[148] (j) the employer's financial condition, (k) whether the employer and employee dealt at arm's length or whether a conflict of interest was indicated,[149] (l) whether the employee guaranteed the employer's debt, (m) whether the employer offered a pension plan or profit-sharing plan to its employees, and (n) whether the employee was reimbursed by the employer for business expenses that the employee paid personally.[150] A compensated control person "probably cannot escape insider status by formally distancing herself from the wage-setting process."[151]

What constitutes "comparable" positions or companies for purposes of executive compensation seems to be a discretionary question on the part of the fact-finder. Courts have rejected expert testimony that failed to provide specifics on the particular executives involved, including both their particular qualifications and skills, and the similarities in the services rendered.[152] Courts have rejected expert testimony that failed to provide specifics on the "comparable companies," including size (annual sales), type of business, number of employees, and business conditions in the areas in which they operate.[153] For-profit companies and PREMERA may not be comparable for purposes of evaluating the reasonableness of executive compensation. The following observations may prove helpful in this regard:

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[147] This is also expressed as "a comparison of the employee's salary with those paid by similar companies for similar services." *Elliotts, Inc.*, 716 F.2d at 1246.

[148] Where a large salary increase is at issue, it is useful to compare past and present duties and salary payments. *Elliotts, Inc.*, 716 F.2d at 1245; *Labelgraphics, Inc.*, 76 T.C.M. (CCH) 518 (1998). In addition, bonuses not paid pursuant to a structured, and formal program, consistently applied, are suspect. *Labelgraphics, Inc.*, 76 T.C.M. (CCH) 518 (1998) (disregarding expert testimony that the executive's 1990 bonus was reasonable, where it was almost three times the size of his 1988 bonus, even though the company enjoyed significantly higher gross receipts, as well as a substantially higher net profit after taxes, for its 1988 fiscal year than for its 1990 fiscal year). "On the other hand, evidence of a reasonable, longstanding, consistently applied compensation plan is evidence that the compensation paid in the years in question was reasonable." *Elliots, Inc.*, 716 F.2d at 1247. A contingent compensation formula is not necessarily unreasonable if it "overcompensates in good years and undercompensates in bad years," and it is also "permissible to pay and deduct compensation for services performed in prior years." *Id.* at 1248.

[149] *See Alive Fellowship of Harmonious Living v. Comm'r*, 47 T.C.M. (CCH) 1134 (1984) (no page numbers available) (stating that "'[o]ne factor to consider [in determining the reasonableness of compensation] is whether comparable services would cost as much if obtained from an outside source in an arm's-length transaction'") (citing B.H.W. *Anesthesia Found. v. Comm'r*, 72 T.C. 681, 686 (1979)).

[150] *Elliotts, Inc.*, 716 F.2d at 1245–48; *Mad Auto Wrecking, Inc.*, 69 T.C.M. (CCH) 2330 (1995).

[151] Frumkin & Andre-Clark, *supra* note 138, at 432–33. Frumkin & Andre-Clark go on to state that *United Cancer Council v. Comm'r*, 165 F.3d 1173 (7th Cir. 1999), suggests "that setting up an independent compensation committee will not protect an influential insider from an inurement finding." *Id.* at 433.

[152] *Labelgraphics, Inc.*, 76 T.C.M. (CCH) 518 (1998).

[153] *B & D Founds., Inc.*, 82 T.C.M. (CCH) 692 (2001).

> It is often assumed in the old reasonable compensation/private benefit cases, and now with the excess-benefit rebuttable presumption, that comparisons can and should be made between the tax-exempt organization and a "comparable" for-profit corporation. The comparability assumption is problematic because it never even raises the question of how the nonmonetary goals and aspirations of the exempt organization should be factored into the decision-making process. Exempt organizations have nonmonetary, mission-driven goals and the outcomes are sometimes intangible, unmeasurable, and even unknown. . . . Further, some have argued that exempt organizations provide nonmonetary rewards for employees which are different from those provided by a for-profit company. These include personal fulfillment and growth opportunities, flexible lifestyles, and, in some cases, prestige from being associated with the nonprofit entity (for example, physicians in teaching-hospital settings).[154]

This may explain, for example, why the position of President of the United States attracts qualified candidates, even though the monetary compensation for serving in this public sector (*i.e.*, nonprofit) position is far lower than the compensation typically paid to the CEO of a large private sector (*i.e.*, for-profit) organization. Indeed, in 1997, the Office of Oversight and Investigation, Council of the City of New York, conducted a study of executive compensation in nonprofit organizations contracting with New York City.[155] The three methods of analysis selected were: (1) comparison to compensation paid by other nonprofits of similar size, (2) comparison to salaries received by government officials responsible for delivering public services, such as the Mayor of New York City and the commissioners of several of the city's agencies, and (3) comparison to the median compensation paid to executive directors of nonprofit organizations of similar size, including a calculation of compensation as a percentage of the organization's total functional expenses.[156] The study made use of a survey conducted by Abbott, Langer and Associates (the "ALA Survey"), an independent management consulting firm known for its surveys of nonprofit organizations across the country.[157] The ALA Survey was selected because of its comprehensive sample size and its widespread use by compensation specialists.[158] Regional differences in compensation levels were

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[154] Consuelo Lauda Kertz, *Executive Compensation Dilemmas in Tax-Exempt Organizations: Reasonableness, Comparability, and Disclosure*, 71 Tul. L. Rev. 819, 856–57 (1997); *see* Frumkin & Andre-Clark, *supra* note 138, at 471 (arguing that allowing a nonprofit corporation to compare compensation of its management to that of for-profit companies "is problematic because it threatens to undermine the fragile identity of [nonprofits] as service and mission-driven organizations where motives and rewards cannot be measured in terms of dollars and cents").

[155] Office of Oversight & Investigation, Council of the City of N.Y., *Report: To Profit or Not-to-Profit: An Examination of Executive Compensation in Not-for-Profit Organizations Contracting With New York City* (1997), *reprinted in* 25 FORDHAM URB. L.J. 471 (1998).

[156] *Id.* at 482–84.

[157] *Id.* at 483.

[158] *Id.*

also taken into account.[159] There is precedent in compensation analysis, therefore, for limiting organizations "comparable" to a nonprofit corporation to other nonprofit entities.

Even assuming that the compensation of PREMERA's officers and directors is currently reasonable by nonprofit standards, and that their compensation by New PREMERA will be reasonable by for-profit standards, a conflict of interest may exist. Because of the fundamental difference in the natures of for-profit and nonprofit corporations, it is likely that officers and directors could expect to receive higher compensation from for-profit New PREMERA than from nonprofit PREMERA. This could create a conflict of interest tainting the decision to convert from a nonprofit corporation to a for-profit corporation. Such a conflict of interest may by itself justify disapproval of the Transaction.[160]

Typically, in a publicly-traded company, the public market favors management compensation that is in line with management in other comparable for-profit companies, especially compensation that is based on incentives such as stock options. In fact, sophisticated investors gain confidence from the alignment of management's interest with their own interests through stock incentives and similar plans. Conversely, if management is not compensated reasonably, then the value of New PREMERA's shares may actually be reduced to the extent that the public market believes that management does not have a sufficient incentive to maximize profits. Investors will prefer that management's interests are aligned with stockholders' interests to the greatest extent possible in order to maximize shareholder value.

The primary information and document required to complete an analysis of self-dealing and conflicts of interest is the executive compensation and benefit plans. PREMERA delivered the plans (at least for the first two years) on October 17, 2003. Prior to that date, PREMERA had only identified, in general terms, the outer limits of the compensation and benefit plans that it would adopt once PREMERA converted. These plans are often very complicated, with numerous provisions that dictate reasonableness or excessiveness. Clearly, if the plans were excessive, this could be considered self-dealing or a conflict of interest. Due to PREMERA's failure to provide these plans prior to the October 15, 2003, deadline to amend the Original Form A, C&B and the other Consultants could not express a conclusion as to whether, in this respect, PREMERA's management engaged in self-dealing, or as to whether there existed a conflict of interest at the time the Final Report was submitted. The Washington Consultants, thus, submitted reports specifically related to the SOP in November 2003. In those reports, the Washington Consultants raised a number of concerns with respect to the SOP and current executive compensation.

The concerns identified by the Consultants have been mitigated to some degree by modifications made to the SOP and assurances provided by PREMERA. As noted by Blackstone,

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159 *Id.* at 488–90.

160 *Cf.* WASH. REV. CODE ANN. 70.45.070(4) (providing that an acquisition of a nonprofit hospital by a for-profit entity may not be approved unless "[n]o conflict of interest exists related to the acquisition, including, but not limited to, conflicts of interest related to board members of, executives of, and experts retained by the nonprofit corporation, acquiring person, or other parties to the acquisition").

and discussed more fully in their Supplemental Valuation Report, these modifications include the following: (1) initial grants to officers and directors are prohibited for a period of 12 months, (2) officers and directors will not be allocated shares as part of the IPO and will not be able to purchase New PREMERA's shares on the open market until 45 days after the IPO, (3) the limitations imposed by Exhibit G-10 are for a period of three years following the IPO (the "Stock Restrictions Period") as opposed to two years previously, (4) any amendments/modifications to the SOP during this three-year period would require a shareholder vote where the Washington Foundation could vote its Shares freely as detailed in the VTDA, (5) the Designated Member will serve on the Compensation Committee during the Stock Restrictions Period, (6) annual limitations on New PREMERA's ability to make grants, and (7) maximum individual grants. There is, however, one outstanding issue, which may, in part, be an oversight by PREMERA. PREMERA had represented to the Consultants that the Foundations would be able to vote their Shares freely on any amendment to the SOP or any new proposed SOP, which was effective during the Stock Restrictions Period, and for any new SOP to be submitted for a vote prior to the Stock Restrictions Period, but effective after such period. The only exception to the foregoing was that the Shares would be subject to a mirror vote for a new SOP submitted to a vote <u>shortly</u> prior to the end of the Stock Restrictions Period, but effective after such period. The language in the VTDA, however, does not comport with this understanding. Section 4.03(d) of the VTDA states that the Washington Foundation will have free voting if the matter concerned is "a subsequent amendment to the Initial Equity Incentive Plan or any new Stock-based Program that would be effective during the Stock Restrictions Period, provided, that any such new Stock-based Program shall not have been submitted to a shareholder vote for approval prior to the date which is 12 months prior to the end of the Stock Restrictions Period." This language suggests that the Washington Foundation may only vote freely on a new SOP when it is submitted during the last 12 months of the Stock Restrictions Period regardless of when such plan was to be effective. If the foregoing was PREMERA's intended result, then it is significantly different from what PREMERA had indicated would be included in the VTDA. Moreover, the result makes no sense. Blackstone believes that this section should be redrafted to reflect what was discussed with PREMERA, which is that the Washington Foundation should have the ability to vote on any new SOP that is effective after the Stock Restrictions Period, but submitted to a shareholder vote during the first two and one-half years of that period.[161]

PwC, however, has raised some concerns involving both, the SOP and the current executive compensation plan, that the Commissioner may consider in making the determination as to whether the compensation to be received by management and directors was a motivating factor in their decision to convert. These concerns are discussed in detail in PwC's Supplemental Executive Compensation Report. To be sure, management and directors will certainly receive significantly higher compensation from New PREMERA as a for-profit company than from PREMERA as a nonprofit company. But, the Commissioner should also consider the extent to which management's alignment with shareholders is important to the public's interest in maximizing the value of the Shares as well as certain safeguards and limitations on compensation to be received by management and directors that were adopted by PREMERA. In sum, although the added compensation that each

[161] The only unresolved issue with respect to this provision was whether the Washington Foundation would be able to freely vote its Shares for an SOP presented during the first two years as opposed to during the first two and one-years of the Stock Restrictions Period.

officer and director will receive is significant, there is not enough evidence to conclude that the prospects of such additional compensation improperly influenced the conversion decision. But the magnitude of these increases in compensation may still provide a basis for concern for the Commissioner.

B. Independence of the Washington Foundation from PREMERA

Among the concerns to which the Original Transaction gave rise, one of the most significant was the complete lack of independence on the part of those that were proposed to govern the Foundation Shareholder and PREMERA. The Amended Transaction, however, provides that the Foundations will be completely independent from New PREMERA. However, as discussed *supra* at section III.C.2.b.(2), with the restrictions on the Washington Foundation's ability to lobby and the funding of those lobbying activities by PREMERA, the company could influence some decisions of the Washington Foundation's Board of Directors indirectly. There may not be enough evidence on the record to justify disapproval based on this potential indirect influence, but when combined with other potential bases for disapproval, the Commissioner may have sufficient evidence on the record to disapprove the Transaction.

C. Stock Transfer Documents and the Transfer of Fair Market Value

1. The Transfer of Fair Market Value

As discussed *supra* at section III.D.2.f, the public interest requires both that the Washington Foundation receive its share of PREMERA's fair market value, and that the Washington Foundation's ability to realize that value in cash not be placed at unreasonable risk by the manner in which the Transaction is structured.[162] Fair market value is "the amount of money which a purchaser willing, but not obliged, to buy the property would pay an owner willing, but not obliged, to sell it, taking into consideration all uses to which the property is adapted and might in reason be applied."[163] The documents that were relevant to this question with respect to the Original Transaction were as follows: (a) the Stock Restrictions Agreement, (b) the VTDA, (c) the RRA, (d) the Stockholder Protection Rights Agreement, (e) the Excess Share Escrow Agreement, and (f) the Indemnification Agreement. The Amended Transaction, however, has eliminated the Indemnification Agreement and the Stockholder Protection Rights Agreement, but has included two new agreements, the TGLA and the Unallocated Shares Escrow Agreement. In order to make a determination as to whether fair market value has been conveyed, the Commissioner will require Blackstone's opinion as to whether the structure of the Amended Transaction is such that the cash value that can reasonably be expected to be realized eventually through the Washington Foundation's sale of stock is reasonably likely to approximate its share of PREMERA's fair market

[162] *Cf.* WASH. REV. CODE ANN. § 70.45.070(5), (6) (providing that an acquisition of a nonprofit hospital by a for-profit entity may not be approved unless "[t]he nonprofit corporation will receive fair market value for its assets" and "[c]haritable funds will not be placed at unreasonable risk, if the acquisition is financed in part by the nonprofit corporation").

[163] *In re Confirmation of Local Improvement No. 6097*, 52 Wash. 2d 330, 333–34, 324, P.2d 1078, 1080 (1958); *see also Black's Law Dictionary* 1549 (7th ed. 1999).

value (adjusted for the time-value of money). Generally, the Washington Foundation cannot reasonably be expected to receive its share of fair market value in cash for the Shares due to the foregoing agreements, because the Washington Foundation will: (1) be under a compulsion to sell, (2) not be free to choose the time or amount of its sale of the Shares, and (3) not be free to sell a controlling block of New PREMERA stock to the highest bidder on the open market. Moreover, though nominally the largest owner of New PREMERA stock, the Washington Foundation will be barred from exercising any of the authority typically and essentially inherent in that position. Thus, the Washington Foundation will be unable to prevent New PREMERA's management from conducting the companies' affairs in a manner reasonably deemed by the Washington Foundation to be inconsistent with its interests and the value of its stock. One problem, however, which has been alleviated, is the reverse ability of New PREMERA to effectively govern the manner in which the Washington Foundation conducts its affairs. That ability, which is no longer available due to the independence of the Washington Foundation from New PREMERA, permitted potential decisions by the Washington Foundation directors that could have benefitted New PREMERA at the expense of the Washington public.

In discussing fair market value with respect to controlling shareholder, the concept of a "control premium" should also be mentioned. When a charitable foundation, in effect, sells 100% of the ownership of a BCBS plan to an acquirer such as WellPoint or Anthem, as in the proposed CareFirst transaction, it is clear that the consideration paid by the acquirer to the foundation must include a control premium. "A 'control premium' typically refers to the additional amount a buyer would pay for a block of shares that would give the buyer control of a corporation."[164] Conversely, "a control premium is realized by sale of a controlling block of stock."[165] If a controlling block of shares is offered to the highest of multiple bidders, all other terms of the proposed sale being equal among bidders, the highest bid will, of necessity, incorporate a control premium. Where there are no competing bidders (*e.g.*, where a single buyer and a single seller have entered into a purchase/sale agreement), a control premium can be taken into account by a valuation consultant in the determination of the fair market value of the controlling block of shares. In the Amended Transaction, there is no third party from which to receive a control premium. Regardless of the potential to receive a control premium through an alternative transaction, the Commissioner must analyze the Amended Transaction, and not an alternative, in order to determine fairness under the criteria of the Holding Company Acts.

Under the Holding Company Acts, the Transaction is unfair because of restrictions upon the Shares that affect the control and marketability of the Shares, and not because there may have been some alternative transaction, which might have satisfied PREMERA's goals while at the same time providing greater value. However, in analyzing the Amended Transaction, the foregoing control premium analysis is still applicable in that the Washington Foundation could receive such a premium by selling a controlling block of the Shares in the open market were it not for the Stock

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[164] *Hawes v. Colorado Div. of Ins.*, 32 P.3d 571, 575 (Colo. Ct. App. 2001), *rev'd on other grounds*, 65 P.3d 1008 (Colo. 2003).

[165] *Foltz v. U.S. News & World Report, Inc.*, 865 F.2d 364, 372 (D.C. Cir. 1989).

Governance Agreements. The divestiture schedule effectively prevents the Washington Foundation from ever receiving a control premium.

> [T]o permit the hypothetical bifurcation of an otherwise integrated bundle of property for valuation purposes would severely undermine the estate tax system and permit abusive manipulation by inviting an executor to invent elaborate scenarios of disaggregated disposition in order to minimize total value. . . . For example, an estate in possession of all shares of a corporation . . . could, under the regime urged by the estate here, arbitrarily slice the . . . block so thinly as to deny attribution of a control premium to any resulting block.[166]

Under these circumstances, the Commissioner would be justified in determining that it is not in the public interest for PREMERA to enter into a Transaction that would result in the inability of the Washington Foundation to ever realize the value of control which could have been obtained in an alternative transaction, or in the Amended Transaction, if it did not contain the restrictions at issue. As discussed in C&B's Final Report, it is unclear whether such an alternative exists. Additionally, consideration should be given to whether PREMERA is attempting a two-step transaction (conversion/IPO followed years later by an acquisition) as discussed more fully in C&B's Final Report. But, there is no strong evidence to suggest that PREMERA is attempting such a transaction.

2. Stock Governance Agreements Generally

Assuming *arguendo* that there is not a viable alternative to the Transaction that provides a greater value to the Washington Foundation, then the Commissioner has to determine whether the Stock Governance Agreements are contrary to the public interest. In the main, these restrictions are spelled out in the VTDA, the RRA, and the Unallocated Shares Escrow Agreement. They do, however, appear as well throughout the other "deal documents," the many instruments through which the conversion is to be implemented. For the most part (but not exclusively), PREMERA attributes the need for the proposed restrictions to the requirements imposed by the BCBSA as a condition of permitting New PREMERA to retain the right to utilize the Blue Cross Blue Shield name and trademark (the "Name and Mark").

Despite being attributed to the BCBSA license, the Amended Transaction does not provide for the restrictions to be eliminated if New PREMERA ceases to be a BCBSA licensee for any reason, nor if the BCBSA eliminates the restrictions as a condition of the license. There being no justification for the restrictions apart from that license, they should be eliminated automatically in either event.

The restrictions that PREMERA proposes to impose upon the Foundations are problematic both, as a matter of principle, and in a very practical sense. In the former category is the fundamental clash of these restrictions with the basic premise that PREMERA belongs to the public

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[166] *Estate of Curry v. U.S.*, 706 F.2d 1424, 1428 (7th Cir. 1983); *accord Foltz*, 865 F.2d. at 372.

in the first instance, and therefore, that the public (through the Foundations as its proxies) must receive all of its existing stock before new buyers (investors in the IPO) contribute capital in exchange for newly issued stock, to be owned by them. In the latter category are the very substantial and negative impacts of the restrictions on the ability of the Foundations to exercise their rights of ownership, both as regards governance, and in realizing the value of the stock. Each of these categories of concerns will be addressed separately.

It is not disingenuous to ask how can the Foundations, as owners of PREMERA, be subjected to the very substantial limitations on the exercise of their ownership rights that PREMERA insists must be part of the conversion? In the main, those rights are the prerogative to guide the affairs of PREMERA and the ability to realize the tangible value of that ownership (including, of course, the right to sell PREMERA). The short answer that PREMERA would offer is that, without the restrictions, the company would be required to cease operating as a BCBS licensee, to its very substantial detriment and the disadvantage of its customers.[167] That may be the case, but the application offers no guidance as to the magnitude of this perceived harm, nor, conversely, the value of preserving the BCBS Name and Mark. Nor does it attempt to quantify the economic impact on the Foundations of the restrictions, which admittedly might require some speculation. Without such information, the Commissioner is simply not able to weigh the cost of the proposed restrictions against the supposed benefit. He cannot therefore, make an informed decision as to whether the public is better served by a transaction in which the Foundations receive fully unrestricted stock in a company that will no longer possess the Name and Mark, than it would be by the Amended Transaction. On this ground alone, the Commissioner may well be justified in rejecting the proposed conversion outright.

PREMERA would likely also respond that the notion that the Foundations are (or will be) the owners of PREMERA is in fact a fiction without substance. It would concede that the decision to convert from nonprofit to for-profit may create an obligation to make some payment to charitable foundations, but it would argue that any such obligation falls short of making those Foundations the real owners of PREMERA. At the heart of this argument, of course, is the troublesome and somewhat metaphysical, question of who really owns PREMERA. To this question there is no ready undisputed answer. To be sure, there are no identifiable owners analogous to those who hold that position in the case of for-profit companies. Nor can it be said, with reason, that the policyholders or insureds are PREMERA's owners, for in no sense is this company a mutual. But neither can it be said that the officers and directors are PREMERA's owners, though they surely seize for themselves one important attribute of that position: the ability to make final decisions about

[167] Notably, however, PREMERA also acknowledges that it is motivated by a desire to "assure the continuity of corporate policy and management and provide stability in the capital markets with respect to the liquidity and divestiture of its Capital Stock." *See* p. 2 of the VTDA. While the last of these considerations may be of value to the Foundations, the application does not demonstrate the value of preserving corporate policy and management. To be sure, that may be very important to PREMERA's current management. That, however, does not equate to the public interest. Interestingly, while the VTDA is a proposed agreement, PREMERA purports therein to recite the desires of the Foundations, which have not yet even been formed. Should the Commissioner otherwise be inclined to approve the Amended Transaction, C&B would recommend that the approval be conditioned, *inter alia*, on removal of such unnecessary and presumptuous recitations.

PREMERA's affairs and future. It may not be necessary in the evaluation of the Amended Transaction to ascertain definitively who owns PREMERA. It may suffice to assure that the people of the states of Washington and Alaska will receive the equivalent of PREMERA's fair market value. But to the extent that the proposed restrictions cause the Transaction to fall short of this standard, it is appropriate to question the basis of those restrictions.

3. Role of the BCBSA

Many of the most controversial aspects of the Amended Transaction, consisting mainly of restrictions to be imposed on the Foundations, are asserted to be necessary for the preservation of the Name and Mark. The Name and Mark is granted by the BCBSA and governed by extensive written agreements attached as Exhibit G-20 to the Amended Form A (the "License Agreement"). Paragraph (9)(d)(iii) of the License Agreement provides for automatic termination of PREMERA's license if:

a. an Institutional Investor becomes beneficial owner of 10% or more of PREMERA's voting power,
b. a Noninstitutional Investor becomes beneficial owner of 5% or more of PREMERA's voting power,
c. any person becomes beneficial owner of 20% or more of PREMERA's ownership interest,[168]
d. the pre-conversion directors (or those they approve by a two-thirds vote) cease being a majority of the post-conversion board, or
e. PREMERA merges without being the survivor (subject as well to the thresholds in subparagraphs a–c, above).

The automatic termination can be waived by the BCBSA upon written request, though the waiver may be conditioned on new, unspecified, conditions. Notably, the License Agreement does not otherwise address the role of conversion foundations, and specifically does not address the applicability of these standards in multi-state conversions. Neither does the License Agreement address on what matters a foundation may vote, or the degree to which it may be represented on the board of directors. Presumably, all of the restrictions addressing such matters are proposed by PREMERA ostensibly as the only way to obtain a BCBSA waiver of the stock concentration restrictions. The problem is that, in the aggregate, these restrictions create a substantial probability that the Washington Foundation will not be able to exercise its independent judgment so as to maximize the value of the Shares. This should be contrasted with the presumption that the public interest requires that the Foundations receive the equivalent of PREMERA's fair market value as part of the conversion. Prior to the submission of C&B's Final Report, PREMERA was given the opportunity, in February 2003, to: (1) provide unequivocal assurances that PREMERA's fair market value would be conveyed to the Washington public, and (2) include adequate measures to assure that the consideration will be structured to take into account potential reductions in fair market value due to the stock restrictions (including those related to liquidity, governance, and marketability) that are

[168] C&B will refer to these first three provisions as the "stock concentration restrictions."

included in the Original Transaction. PREMERA elected not to address these concerns. PREMERA might have sought to assure the OIC that the restrictions were necessary to maintain the Name and Mark, and that it had done everything in its power to avoid the imposition of the restrictions while still maintaining the Name and Mark. It provided no such assurances. Neither did the company attempt to assure the OIC that the restrictions were not otherwise unfair or contrary to the public interest. During numerous informal discussions that followed submission of the Consultants' reports in October, 2003, PREMERA has attributed the offending requirements to the BCBSA licensing conditions. More recently, the applicant has advised that the BCBSA would not relent on its requirement that a single divestiture schedule be applied to the two Foundations, and on other conditions deemed by the Regulators or Consultants to create substantial problems. In Section 4.3(a)(xv) of the Plan of Conversion, PREMERA does propose to require the BCBSA's approval as a condition of the conversion. Given, of course, that the BCBSA is not a governmental regulatory authority, and its approval is not a requirement under the Holding Company Acts, this provision is defensible only in the context of weighing the value of the Name and Mark against the burden of the proposed restrictions.

In any event, however justified, the requirement for the BCBSA approval must be understood to be strictly a matter for PREMERA itself. The Regulators and Consultants have not thus far participated in any discussions or negotiations with the BCBSA, and they may prefer not to do so in the future unless the BCBSA submits to the regulatory authority of Washington and Alaska officials. It has become sadly axiomatic that in many Blue Cross conversions, the BCBSA plays the role of the invisible but ultimate arbiter of key provisions. And yet, no intelligible explanation has been offered for some of the most troublesome restrictions imposed in the association's name. For example, while preserving the value of the Name and Mark seems like a reasonable goal, it is not evident that entrenching the pre-conversion board of directors is important (let alone essential) to that goal. Neither is it obvious that imposing the stock concentration restrictions accomplishes that result.

PREMERA reports that it has held informal discussions with the BCBSA's staff about imposing lesser restrictions on the Washington Foundation that were similar to the ones imposed in the conversion of the Empire BCBS Plan in New York (the "WellChoice Conversion"). PREMERA has indicated that those discussions were not fruitful. But, it should be noted that those informal discussions need not be the end of the process by which PREMERA can seek the BCBSA's approval. The BCBSA's staff can only make a recommendation to approve or disapprove the Amended Transaction to the BCBSA's Plan Performance & Financial Standards Committee (the "PPFSC"). The PPFSC, however, is not bound by the staff decision, and will in turn, make its own decision as to whether the Amended Transaction complies with the BCBSA's rules. If the PPFSC does not approve the Amended Transaction on terms acceptable to the Commissioner, PREMERA can appeal the decision to the BCBSA's Board of Directors. Again, the BCBSA's Board of Directors is not bound by the PPFSC's decision. If the BCBSA Board of Directors rejects the Amended Transaction, then PREMERA can appeal to the full BCBSA membership for a vote. Thus, PREMERA has several procedural steps to complete prior to submitting an Amended Transaction with more severe restrictions than those imposed by prior conversions or with conditions unacceptable to the Commissioner. There is no evidence that PREMERA has taken even the first step, (formal submission of an appropriate plan to the BCBSA's staff). Any suggestions that this process may take too long should be evaluated in the context of PREMERA' decision not to commence it until after the Final Reports were submitted. PREMERA had been apprised of the Consultants' key concerns many months before that submission and elected not to begin then the process of obtaining the requisite BCBSA approvals. Assuming that each of the proposed restrictions are deemed absolutely necessary to maintain the License Agreement, the potential loss of the Name and Mark must then be found to be more detrimental to PREMERA's value than the Washington Foundation's loss in value of the Shares due to the restrictions. In the absence of such finding, the Amended Transaction can be deemed to fail the applicable legal requirement that fair market value be conveyed to the Washington Foundation.

Even if the BCBSA requires certain restrictions, and if the Mark's value is found to outweigh the adverse consequences of the restrictions, PREMERA has not demonstrated that it has done everything reasonable in its power to avoid the imposition of the BCBSA's restrictions on the Washington public. For example, PREMERA could make a legal challenge to the enforceability of the License Agreement's requirement that the BCBSA approve any of the restrictions in a conversion (*e.g.*, PREMERA could claim that the arbitrary way in which such restrictions are imposed among the various conversions is contrary to public policy, or the imposition of the restrictions in the first place is against public policy). Regardless of the BCBSA's decision, and the enforceability of any provision in the License Agreement, imposing restrictions upon the Washington Foundation that are more onerous than those that have been imposed on other foundations in other states is fundamentally unfair and not in the public interest. Interestingly, the BCBSA generally uses precedent transactions as an excuse for not permitting more lenient restrictions. It is certainly significant that there have been comparable transactions in which the BCBSA has not revoked the converting company's license even though less severe restrictions have been permitted such as the WellChoice Conversion. The implicit conclusion in these precedent transactions—that lesser restrictions do not fatally threaten the Name and Mark—need not be ignored by the Commissioner. Moreover, if the BCBSA has been more "lenient" in precedent transactions, then there is no reason that the Washington public should be compelled to accept more restrictive provisions. In the end, PREMERA has not provided a persuasive rationale as to why the Washington public should endure the proposed restrictions, restrictions which (at least in some cases) are even more onerous than those that have been imposed in other conversions. Indeed, it has not even shown that the proposed restrictions are required by the BCBSA, or that, if so required, they are necessary for the preservation of the value of the Name and Mark. Without a compelling showing to the contrary, the Commissioner would be justified in concluding that the restrictions impair impermissibly the ability of the Foundations to realize the requisite value.

The following sections discuss specifically certain provisions in the Stock Governance Agreements that are more onerous than those imposed in the WellChoice Conversion or other conversions, or that are otherwise unfair and contrary to the public interest.

4. Voting Trust and Divestiture Agreement

The VTDA complies with WASH. REV. CODE ANN. § 23B.07.300, but some provisions are not in the public interest. The proposed restrictions in the VTDA address primarily: (1) the voting rights of the Foundations, which will initially own all or the vast majority of New PREMERA's stock, (2) the extent to which the Foundations will be able to elect New PREMERA's directors or otherwise have representation on New PREMERA's board of directors, (3) the timing of the Foundations' sale of New PREMERA stock, and (4) the mechanisms by which the Foundations will be able to effect such sales. The pervasive effect of the restrictions proposed by PREMERA is more easily understood when compared to the rights of stockholders in non-Blue Cross publicly traded companies. Under those "market" circumstances, the typical holder of a majority, or even a significant portion, of a company's outstanding shares has the unfettered right and ability to: (1) vote in its sole discretion the holder's shares on any matter as to which, under the company's articles of incorporation of bylaws, the shareholders have a right to vote, (2) elect at least some directors (without any need that such directors be approved by the rest of the board), and (3) sell all or part of the holder's stock whenever the holder decides that it is in its interest to do so (or to never sell any of that stock). In addition, when the stock has not already been registered and is not already traded on the relevant exchange, large holders are often given the right to compel the registration of that stock ("demand registration rights") so that it can be sold on the relevant exchange. They are also typically authorized to sell that stock in private transactions and through other mechanisms. To these broad prerogatives should be compared the restrictions under which the Foundations would be compelled to operate in the Amended Transaction.

a. Divestiture Schedule

Among the most troubling conditions is the proposed "divestiture schedule" at the heart of the VTDA, which will compel the Foundations to reduce their holding of New PREMERA's outstanding stock to: less than 80% by the first anniversary of the closing of the IPO, less than 50% by the third anniversary, less than 20% by the fifth anniversary, and less than 5% by the tenth anniversary.

These deadlines may be extended somewhat by New PREMERA's imposition of "blackout" periods during which the Foundations may not be able to sell their stock. They may also be extended upon a showing by a Foundation that they would have a "material adverse effect on the [Foundation]'s ability to maximize the value of its assets or would be in conflict with the [Foundation]'s legal or fiduciary duties" if the foundation obtains approval of the BCBSA for such extension. VTDA § 7.05. Of course, given that there can be no assurance of such approval, the Commissioner should assume that extensions under this provision will not be available. Remarkably, these periods may also be extended unilaterally by New PREMERA (with BCBSA approval) when doing so would be good for the company or its other shareholders.

This divestiture schedule is the direct result of the BCBSA requirements, ostensibly aimed at preserving the value of the Name and Mark, but arguably accomplishing nothing more than the entrenchment of current management and preserving the artificial and arbitrary exclusivity of the universe of potential owners of significant stakes in Blue Cross plans. The importance of the divestiture schedule to the Foundations is that it restricts very significantly their ability to make decisions in accordance with their own interest as to how much of their Shares to sell, and when to sell them. In a nutshell, they may be compelled to sell significant portions of their Shares at a time when the market makes such sale less than optimal. Assuming, however, that the rationale underlying the divestiture schedule is sufficiently persuasive (a proposition that remains open to question), there is in the Amended Transaction an even more pernicious and indefensible requirement. PREMERA proposes to subject the Foundations to a single combined divestiture schedule as if they were a single stockholder. For this mandate, about which Consultants have voiced severe concern to the applicant, PREMERA offers no justification other than to assert that it is required by the BCBSA.

In the Original Transaction, PREMERA would have accomplished this deplorable goal by combining the stock-holding functions of the two Foundations into a single "Foundation Shareholder." As proposed in the Original Transaction, the single Foundation Shareholder would have received all of the Shares, the proceeds of the eventual sale of which it then would have distributed to two Charitable Organizations, one in each state. The Foundation Shareholder would have voted (subject to extensive restrictions), and controlled the sale of all of the stock. As early as February 2003, the Regulators informed PREMERA that their preliminary review had revealed several "Structural Issues" inherent in the Original Transaction of substantial concern in the context of the applicable statutory standards. Among other things, the Regulators suggested that PREMERA amend the Transaction to provide for the separation of the Alaska and Washington Shares *ab initio*, so that if the approach then proposed were retained, there would be two Foundation Shareholders and two Charitable Organizations, one each for Alaska and Washington. If a structure were to be adopted that eliminated the Foundation Shareholder, then the reviewers recommended that the consideration be delivered directly to the two Charitable Organizations.

As noted in C&B's Final Report, PREMERA neither responded to these concerns nor provided an explanation as to why the structure in the Original Transaction should be maintained.[169] Of course, as noted previously, PREMERA had declined to respond to the Structural Issues List, as a whole, expressing a desire to avoid "piecemeal" changes to the Transaction. Although this position may not be wholly unreasonable under some circumstances, it is at best naive in the context of a conversion of this level of complexity. Notably, precedent transactions proceeded in the very manner suggested by the Regulators. In any event, PREMERA's stance did result in other negative consequences. One of those consequences was the postponement, until recently, of the exchange of views between PREMERA, the Regulators, and the Consultants concerning fundamental elements of the conversion. As demonstrated by the results produced with respect to other areas of the Amended Form A, some substantial progress would have been possible to alleviate the Regulators' and Consultants' concerns. In other areas such as the restrictions imposed on the Shares, this process has uncovered numerous problems and difficulties which have resulted in fundamental

[169] During the course of more recent discussions, PREMERA did articulate that, in its view, it would be easier to attain § 501(c)(4) status with the structure in the Original Transaction. But, as indicated by PwC, achieving § 501(c)(4) tax status with two Foundations would be more probable than with the one Foundation Shareholder structure.

changes to the Original Transaction. These, fundamental changes to a Transaction of this magnitude and complexity, in turn, revealed additional issues, primarily regarding the proposed delivery of the Shares to two Foundations as opposed to one Foundation Shareholder. But, PREMERA had elected to forego the opportunity to have such exchanges and respond with improvements to the Original Transaction. Then, in anticipation, and following the completion, of the Consultants' first round of critical reports in October, PREMERA revised its views and began soliciting a dialogue of the kind that the Consultants had been advocating for nearly a year.

As detailed discussions between PREMERA, the Regulators, and the Consultants ensued over the last two months, it became obvious that the Consultants continued to perceive very substantial problems with the proposed separate and distinct shareholders under the umbrella of one Foundation Shareholder. As would be expected, each state to which a charitable obligation is owed, although cooperative with the other, may have differing views as to when the Shares that are allocated to that state should be sold, how to vote such Shares, and whom to appoint to PREMERA's Board of Directors. These issues had always existed, but were never addressed by PREMERA in the Original Transaction. Indeed, even in the Amended Transaction, these issues are addressed only to a limited degree, and rather ineffectively. As revealed during the in-depth discussions held over the past two months, it became clear that the stock must be distributed to two Foundations as separate shareholders. As separate and distinct shareholders, of course, the Foundations should be treated as independent from each other in all respects. But what PREMERA has done in acceding to the inevitability of separate shareholders for the two states, is to create a mechanism to limit many of their stockholders' rights, as if they were still a single shareholder, most notably by imposing a single combined divestiture schedule. There is no good reason for doing so.

Even the most cursory glance at a map of North America would reveal to the authors of this incredible requirement that Washington and Alaska are not separated merely by a state line, but by a whole country, their state capitals being 1,500 air miles apart. Nor is there the slightest basis for concluding that the two Foundations will in any sense be one entity. They will be dedicated to serving the interests of two distinct and separate states and be governed by completely separate boards appointed by officials of each of separate state. Not even has PREMERA sought to demonstrate that the two Foundations would in any sense act in concert with respect to their stock-sale decisions (a proposition that, under the circumstances, would defy logic in any event). In short, the only reason for treating these two Foundations as if they were one, is to further hamper the ability of the states of Washington and Alaska to freely trade their stock, and thereby realize the fair market value of PREMERA as part of the proposed conversion. Without more, the Amended Transaction fails the requirements of the Holding Company Acts because it will not transfer fair market value to the Foundations.

That the combined divestiture schedule creates substantial disadvantages for the two Foundations is self-evident in some respects and revealed in others by analysis of key provisions of the VTDA. Most importantly, combining for the two Foundations the divestiture schedule intended to be applied to individual shareholders has the inexorable effect of accelerating the pace at which each of the Foundations must sell its New PREMERA stock. Thus, for example, assuming hypothetically that the Washington Foundation were allocated 85% of New PREMERA's outstanding stock, 15% being allocated to the Alaska Foundation, the acceleration for the two Foundations would be immediate. With separate divestiture schedules, the Washington Foundation would be required to sell only 5% of stock by the first trigger date.[170] It would face its first material deadline on the third anniversary of the IPO's closing, by which it must have sold another 30% of New PREMERA's outstanding stock (35.3% of its holdings). The Alaska Foundation would face even less pressure. At 15% it would be below the penultimate trigger point and would not face a deadline until the tenth anniversary of the IPO's closing, by which it must have sold 10 % of New PREMERA's outstanding stock (66.7% of its holdings).

In contrast, with the combined schedule (applied proportionately per § 7.08 of the VTDA), the two Foundations together will be required to sell 20% of New PREMERA's outstanding stock within the first year of the IPO, even though Alaska is not at the first threshold, and Washington is only 5% from that threshold. Of this compulsory 20% divestiture, 85% (17% of New PREMERA's outstanding stock) must come from the Washington Foundation, the remaining 15% (3% of New PREMERA's outstanding stock) being required from the Alaska Foundation. The acceleration continues throughout the life of the divestiture schedule. The effect, of course, is even more perverse for the Alaska Foundation. Assuming the 85/15 allocation hypothesized above, with separate schedules that foundation would have no trigger points until the tenth anniversary of the closing of the IPO. With a combined schedule, it faces all the trigger points, even though it begins below the penultimate threshold. The following table demonstrates the acceleration throughout the life of the divestiture schedule (based on the hypothetical 85/15 split):

Amount of New Premera's Outstanding Stock Each of the Foundations must Have Sold by Each Trigger Point:

IPO	INDIV SCHED		COMBINED SCHED	
ANNIV	WA	AK	WA	AK
1ST	5	0	17	3
3RD	35	0	42.5	7.5
5TH	65	0	68	12
10TH	80	10	80.75	14.25

But the problems do not end there. Article VII of the VTDA, which governs divestiture by the Foundations of their New PREMERA stock, does not just combine the schedules. It also requires the Washington Foundation to reduce its holdings sufficiently to comply with the combined schedule in the event that the Alaska Foundation fails to do so. Thus, if (for whatever reason) the Alaska Foundation fails to sell any stock during that first year, the Washington Foundation would have to sell 20% of the total outstanding, which presumably would be a materially greater

[170] To be precise, the Washington Foundation would be required to sell one share more than 5% of the shares during the first year, because the VTDA requires that it own <u>less</u> than 80% by the first anniversary of the IPO's closing.

percentage of the Washington Foundation's own stock.[171] Similar requirements apply to the other trigger points in the divestiture schedule, although only the first would be eliminated with the approval of the BCBSA. The reverse is apparently not true. Sale by the Alaska Foundation of 15% of New PREMERA's outstanding stock does not relieve the Washington Foundation of the obligation to sell 20% of its holdings during that first year as indicated in section 7.08 of the VTDA. These forced sales can only serve to increase the adverse effect of the divestiture schedule in the first place. More importantly, imposing on one Foundation the adverse consequence of the other's failure to comply with the divestiture schedule is wholly unjustified, and theoretically permits the latter to time the markets at the direct expense of the former.

Compounding these issues is the effect of the combined divestiture schedule on the demand rights of the Foundations. In discussions with PREMERA, representatives of Washington and Alaska proposed a method for reconciling two states' competing requests for the right to compel New PREMERA to register stock to be sold by the Foundations, as discussed more fully in Blackstone's Supplemental Valuation Report. However, the suggested mechanism was premised on the logical assumption that the BCBSA-mandated divestiture schedule would apply separately to each of the Foundations. The combination of the divestiture schedule as incorporated in the Amended Transaction may have the effect of undermining the proposal for reconciling demand rights. This "intra-mural" schedule may not provide the Washington Foundation adequate or sufficient opportunities to sell its stock under the schedule accelerated as a result of the combination.

Even assuming, *arguendo*, that imposition of the divestiture schedule is not found to require disapproval of the Amended Transaction, the absence of any justification for the combined divestiture schedule may compel that result.

In addition to the problems inherent in the imposition of a divestiture schedule in the first place, and the compounding of these problems by the proposed imposition of a single divestiture schedule upon both Foundations jointly, there is a further problem. PREMERA proposes to further accelerate the divestiture schedule by requiring that the Foundations sell at least 10% of their combined stock holdings in the IPO. This requirement is not found in the VTDA, as might be expected, but in section 2 of the Unallocated Shares Escrow Agent Agreement. The Foundations may well find it appropriate to sell a portion of their stock holding in the IPO in order to generate funds for their operations, or for other reasons. But the discretion to do so should be left entirely to the Foundations themselves. No defensible explanation has been offered for this further acceleration of the divestiture schedule and none has been identified by C&B. Quite apart from the foregoing problems, another concern arises as to the first sell down requirement (down to 80% by the first anniversary of the IPO). In the WellChoice Conversion, a precedent transaction, no such requirement was imposed by the BCBSA. An issue that resonates throughout the various agreements proposed by PREMERA is the unfairness of permitting other states to receive more favorable terms than the State of Washington.

[171] For example, if initially the Washington Foundation receives 85% of New PREMERA's outstanding stock and the Alaska Foundation receives 5%, under these circumstances, the Washington Foundation would be compelled to sell 23.5% of its holdings.

b. Stock Outside the Voting Trust

The VTDA requires generally that the Foundations largely surrender their right to vote appurtenant to the stock they would receive under the transaction, this requirement being implemented by placing most of such stock in a voting trust.[172] However, the BCBSA requirement underlying this condition applies only to holders of 5% or more of a plan's voting stock. Therefore, PREMERA agreed originally (as was done in WellChoice) to exempt from this requirement that number of foundation shares (the "Voting Shares") that equal one share less than 5% of New PREMERA's voting stock. The Amended Transaction permits each of the Foundations to place "outside the voting trust" the number of shares constituting the Voting Shares (effectively enabling two shares less than 10% of those outstanding to be voted freely by the Foundations). However, the VTDA provides that if: (1) the BCBSA disapproves of the grant to each state of free Voting Shares, and (2) the states do not agree to allocate a single 5% free voting allotment among themselves, then only the Washington Foundation shall have free voting stock. While clearly favoring Washington, this provision is nothing short of arbitrary. Moreover, it delegates to the BCBSA a material element of the Transaction, presumably to be resolved in non-public deliberations outside the scope of this proceeding. Because there obviously is no way to predict how this issue will be resolved by the BCBSA (leaving aside cynical suspicions born of experience), the Commissioner will have no alternative but to assume the worst-case scenario: only one allotment of Voting Shares will be permitted to the two Foundations. Whether divided among them, or assigned exclusively to Washington, this result would be patently unfair. In the WellChoice Conversion two foundations within the State of New York, were each allowed to hold 5% of the WellChoice stock outside any voting agreement.[173]

Furthermore, Section 10.01 of Article X states that the Foundations together must own less than 5% of the issued and outstanding Shares, although PREMERA in the first instance purports to allow each of the Foundations to hold 5% outside the voting trust. Although C&B recognized that there is a substantial probability that ultimately PREMERA will require that the Foundations together hold no more than an aggregate of 5% outside the trust (*i.e.*, PREMERA will be unable to persuade the BCBSA to accede to each of the Foundations' rights to hold 5% outside the trust), this does create another apparent inconsistency within the VTDA.

The inclusion of this voting trust is solely the result of PREMERA's desire to prevent the Foundations from exercising freely this important attribute of ownership of the stock (even if required by the BCBSA). Yet, the Washington Foundation will be required by sections 9.02 and 9.03 of the VTDA to pay for at least a portion of the cost of the trust. Under the circumstances, these costs should be borne entirely by New PREMERA.

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[172] While the VTDA discusses at length what the trustee may and may not do, it does not specify who will be the trustee or how the trustee will be selected. No answer to these questions is found in the other "deal documents."

[173] One of the New York foundations held 5% only, and thus, a voting trust agreement was not entered into with that foundation. However, the analogy remains valid in that the BCBSA could have compelled the foundations to aggregate their shares, and thus, no more than a total 5% of the shares would have been eligible to be held outside the trust as opposed to 10%.

c. Voting of the Shares by the Trustee

The VTDA specifies how the trustee is to vote the Shares on a number of matters. In most cases the trustee must vote all the Shares as recommended by, or consistent with the initiatives of, the Independent Board Majority (consisting generally of those directors not associated with New PREMERA or the Foundations). In other cases, the trustee must "mirror" the vote of holders other than the trust, the Foundations and New PREMERA. In a few cases, the Foundations may vote their stock (in or out of the trust) freely.

An issue that has arisen with respect to the Independent Board Majority is whether they are truly independent. The Washington Foundation has a significant interest in ensuring that the Independent Directors do not have any direct or indirect material relationship with New PREMERA, because the Independent Directors will be controlling the voting of the Shares on many issues. The SEC prescribes certain regulations to ensure that public corporations have independent directors as that term is defined by federal regulations. However, the Foundations have an additional interest in ensuring that New PREMERA has directors that are truly independent from New PREMERA. As mentioned above, New PREMERA will control the voting of the Shares on almost all issues. The Washington Foundation, therefore, has an incentive above and beyond that of a typical shareholder to ensure that New PREMERA's directors are independent. There is one material outstanding issue with PREMERA's qualifications for Independent Directors. Section 4(f) of Article II of the Bylaws states that a director is not independent if the director is employed by another company, which accounts for the greater of 2% or $1 million of New PREMERA's gross revenues. Blackstone is concerned because "A company accounting for 2% of [New] Premera's revenues would generate $57 million in total revenues and could potentially be a significant contributor to [New] Premera's earnings."

With respect to free voting, PREMERA would permit such free voting of Shares for proposed changes in control only of more than 50% of New PREMERA. Like Blackstone, C&B believes that this threshold should be lowered to changes in control of 20% or more of New PREMERA, because transactions of this magnitude would certainly be of material effect to the interest held by the Foundations. The rationale behind lowering this threshold is that the Washington Foundation, although prevented from having day-to-day control over New PREMERA's operations, should still have the ability to voice its opinion on major corporate transactions. Furthermore, Blackstone notes that the New York Stock Exchange, on which PREMERA intends to list its shares, requires a shareholder vote on any transaction that would result in the dilution of more than 20% of a company's outstanding shares.

Additionally, PREMERA provides that the Washington Foundation will have the right to vote freely on any amendment to the initial SOP or a new SOP if effective within the Stock Restrictions Period. But, as discussed with PREMERA, it was to provide for free voting for any new SOP that was effective after the Stock Restrictions Period but introduced shortly prior to the end of that period. The VTDA, however, does not contain such language. Section 4.03(d) states that the Washington Foundation will have free voting if the matter concerned is "a subsequent amendment to the Initial Equity Incentive Plan or any new Stock-based Program that would be effective during the Stock Restrictions Period, provided, that any such new Stock-based Program shall not have been submitted to a shareholder vote for approval prior to the date which is 12 months prior to the end of the Stock Restrictions Period." This language suggests that the Washington Foundation may only vote freely on a new SOP when it is submitted during the last 12 months of the Stock Restrictions Period. If the foregoing was PREMERA's intended result, then it is significantly different from what PREMERA had indicated would be included in the VTDA. Blackstone believes that this section should be redrafted to reflect what was discussed with PREMERA, which is that the Washington Foundation should have the ability to vote on any new SOP that is effective after the Stock Restrictions Period, but submitted to a shareholder vote during the first two and one-half years of the Stock Restrictions Period.

d. Nomination, Election and Term of Directors

The VTDA generally prohibits the Foundations from nominating or supporting the candidacy of directors, one of the more important prerogatives of a shareholder. However, for as long as they each own 5% or more of New PREMERA's outstanding stock (but for no longer than five years), the Foundations may jointly propose a slate of three nominees from which the board will select one to serve a two-year term as a director on New PREMERA's board of directors (the "Designated Member"). The nominees must meet stated qualifications and may nonetheless all be rejected by the board. The Designated Member will serve on the Executive and Compensation committees of the board for three years and on the Pricing Committee for so long as there is a Designated Member. The VTDA does not articulate by what means the Foundations are to "jointly" propose the slate of nominees. C&B believes that the five year limit on this representation is not justified. Interestingly, this is one of reasons which compelled the states to suggest to PREMERA that having one Foundation represent both states would be an unworkable structure. The State of Alaska's position was that it should have significant input as to who the representative member would be on behalf of the Foundation Shareholder. Although this was a reasonable position, the State of Washington felt just as strongly in its position that, as a significantly larger shareholder, the Washington Foundation should determine who would be the Designated Member. PREMERA seems to have implicitly realized this difficulty because the Amended Transaction provides that one Designated Member will be appointed jointly, but does not provide a mechanism by which the joint appointment would occur. Even with the accelerated combined divestiture schedule, the Washington Foundation is likely to have far more than 5% of New PREMERA's outstanding stock by the fifth anniversary of the IPO closing. Moreover, there is also no justification for permitting New PREMERA to veto all three of the Foundations' nominees who otherwise meet the stated qualifications. It should be noted that the qualifications for membership on New PREMERA's Board of Directors as Designated Member are very stringent. Thus, no reasonable argument can be made that New PREMERA requires this veto right in order to prevent marginally qualified candidates from being proposed by the Foundations. Finally, just as the combined divestiture schedule makes no sense given the independence of the Foundations from each other, neither is it reasonable that the Designated Member be their joint representative or designee. Denial by PREMERA of adequate representation on the board for the Foundations that will be the largest shareholders is contrary to the public interest and may suffice as an independent reason for rejecting the conversion.

PREMERA may suggest that the restriction originates with the BCBSA. If so, this position is more stringent than what it required in precedent transactions. For example, in the WellChoice Conversion, the foundation received a full Designated Member. In this case there are two shareholders each of which deserve a separate board member to represent its interests, especially because PREMERA has prevented each state from having unfettered voting control over most of the Shares. Furthermore, it is not unreasonable to allow each major shareholder to have at least some voice, however minor, on the board.

The BCBSA knows how to accommodate a BCBS plan when it finds that it is in the association's best interest. It has allowed five members presenting nearly 25% of the voting members of a board to be appointed by some group other than the current board of a BCBS plan to replace five current outgoing members in a non-conversion situation such as in Maryland.[174] Moreover, such group would have the right to certify a pool of applicants (the "Certified Pool") from which the board of the BCBS plan would be requested to select another seven members representing approximately 33% of the board to replace seven current outgoing board members. The irrationality of PREMERA's position is even more telling considering that in Maryland the board appointments to, and the Certified Pool created for, the Maryland BCBS plan, CareFirst, are selected by the Maryland legislature through a nominating committee, and not a shareholder. There are obviously some clear differences between the Amended Transaction and the CareFirst situation, but there are also some similarities depending on the perspective from which they are viewed. From the perspective of an outside party, the Washington Foundation would be appointing the board members to protect its economic interests. The Maryland legislature, however, would be appointing board members or creating a pool of applicants to safeguard the public interest in accordance with Maryland's statutes. But, from the perspective of the BCBSA, which is the perspective that is the most relevant for purposes of this requirement in the Amended Transaction, little argument can be made that one Designated Member appointed by a Washington Foundation, which has limited voting rights, is somehow more detrimental to the interest the BCBSA purports to protect, whatever that may be, than the Maryland legislature's influence on the majority of the CareFirst board, which will essentially have control over day-to-day operations of the company and a large influence on major corporate transactions. In short, the BCBSA has already acceded in other cases to greater concessions on this point than are sought here by the Foundations. Whether for its own reasons, or in reliance on the BCBSA, PREMERA should not be permitted in this proceeding to deny the Foundations adequate board representation. Without it, the "value" to be delivered as part of the conversion might be found to fall sufficiently short of the mark as to warrant rejection of the application altogether.

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[174] A Nominating Committee was formed by the Maryland General Assembly to replace 12 of the 21 members of CareFirst's Board of Directors, of which two directors will be consumer members. Moreover, the President of the Senate of Maryland, and the Speaker of the House of Delegates will each appoint one additional nonvoting member to the board, thereby increasing the board to 23 members.

e. Termination of VTDA Upon Termination of the BCBSA License Agreement

PREMERA indicates that the VTDA will not terminate if the License Agreement is terminated. At the outset, it should be noted that this provision is not a requirement of the BCBSA, because once the Name and Mark are lost, the BCBSA has no contractual agreement with PREMERA. Thus, any argument that this is a required provision in order to keep the Name and Mark must necessarily fail. Moreover, PREMERA has articulated no good reason as to why the VTDA should not terminate if the Name and Mark is lost. One might understand an argument for preservation of the RRA, as beneficial to all parties involved by ensuring that the sale of the Shares is done in an orderly fashion. But, imposing voting restrictions upon the largest shareholder when the BCBSA has no voice in PREMERA's operations is unthinkable. PREMERA may argue that it would never go public if management would have to relinquish control to the owners of the Shares. But, this reasoning is flawed on several fronts. First, PREMERA is suggesting that management's control over PREMERA somehow played a part in the decision to become for-profit. That factor should have no role in management's decision that PREMERA should convert. An appropriate factor might be whether, from a business standpoint, PREMERA is better off as a for-profit company as opposed to a nonprofit company, but whether management will be entrenched is not. This should come as no surprise to the Commissioner. The restrictions required by the BCBSA, of which PREMERA is a voting member, are essentially entrenchment devices that permit management to experience the best of both worlds. That is, management will be able to retain control over New PREMERA, as if it were a nonprofit company, but at the same time able to enjoy the benefits of being a for-profit company such as increased compensation, increased likelihood of completing a successful merger coupled with the bonuses of such a merger, and access to capital in the public markets. Put more starkly, these provisions enable management to sell the company (through the conversion and IPO) while retaining control.

f. Class B Share

While New PREMERA's proposed Articles of Incorporation contemplate that the Washington Foundation will receive the one share of Class B Common Stock (the "Class B Share") to be issued by the company, no provision appears to have been made for the actual issuance or delivery of the Class B Share to the Washington Foundation. The Class B Share is designed to facilitate the exercise, by the Washington Foundation, of an unrestricted vote upon certain recapitalization, restructuring, and stock issuance transactions that would have an adverse effect on specified financial interests of the Washington Foundation. Although the absence of a provision for delivery of this stock may be the result of oversight, C&B believes that it should be remedied or clarified by a simple recitation in an appropriate document such as the VTDA.

5. Unallocated Shares Escrow Agreement

The Amended Transaction contemplates (as did substantially the Original Transaction) that, before the closing of the IPO, all of the outstanding stock of New PREMERA will be owned collectively by the Washington Foundation and the Alaska Foundation. However, the Amended

Form A does not allocate that stock between these Foundations, leaving to the states the determination of how much of the "charitable contribution" delivered pursuant to the Amended Transaction will be conveyed to each state. Officials of Washington and Alaska are currently engaged in a process to resolve that allocation. Assuming, as do the parties, that as a condition of its conversion, PREMERA must satisfy charitable trust obligations in the two jurisdictions, arguably this failure to specify the allocation of the Shares constitutes a fatal defect in the application. Seeking to avoid this consequence, PREMERA has proposed that each of the Foundations receive that portion of the Shares which is not in dispute, with the undetermined amount being placed in an escrow.

PREMERA does not identify what portion of the initial stock will be conveyed to each of the Foundations and what portion will be placed in the Unallocated Common Shares Escrow (the "Escrow"). Presumably, it expects to be advised by representatives of each state of the amount of the stock that can be allocated between the two Foundations without controversy, placing the rest in the Escrow. This mechanism, as proposed to be implemented, suffers from a number of serious infirmities.

First, if the amount of stock to be placed in the Escrow is sufficiently small, the concept of an Escrow might be workable under certain circumstances. But if the uncertainty as to the proper allocation of the Shares among the states is of sufficient magnitude, placing the amount as to which there is uncertainty in the Escrow might impair substantially the ability of the Foundations to make sufficiently informed decisions as to how to sell the stock allotted to them.

Second, for no apparent reason, the Unallocated Shares Escrow Agent Agreement proposes to impose upon the Foundations a requirement that they sell an aggregate of 10% of New PREMERA's outstanding stock in the IPO, failing which the Unallocated Shares Escrow Agent is to make such sales from the stock in escrow.

Third, PREMERA proposes to shift to the Foundations (by deducting from the Escrow) the full economic burden of this mechanism. Moreover, the Foundations are required to indemnify the escrow agent in a variety of cases. Under the circumstances, if the Escrow were otherwise deemed a reasonable device, its costs (including indemnification obligations) should be borne partly, or entirely, by PREMERA, because the Escrow is created solely for its benefit, so that the transaction may proceed before the allocation issue is resolved.

Fourth, the Escrow, in instances where the VTDA allows the Washington Foundation to vote the Shares freely, transfers the voting of the Shares to New PREMERA, unless otherwise agreed to by the Foundations. Again, the Escrow does not solve the problem of who votes the Shares. Clearly, transferring the voting rights cannot be a viable solution, nor can merely shifting the problem to the Foundations be a viable solution.

Fifth, the Unallocated Shares Escrow Agent Agreement does not explain how the Unallocated Shares Escrow Agent is to be selected or qualified. Presumably, the initial appointment will be by PREMERA. That is expressly true under section 23 of successor escrow agents. No role appears to be contemplated for the Foundations in that process.

6. Registration Rights Agreement

The RRA is the mechanism governing rights and limitations, which consisting generally of "demands" and "black-out periods" of the Foundations' ability to sell their Shares in the public market. Many of the problematic provisions of the RRA have been resolved to the satisfaction of Blackstone with the exception of the ability "to continue a Company registration in which Premera has decided to withdraw." As stated by Blackstone in its Supplemental Valuation Report, "The inability to continue a registration would delay the Washington Foundation's ability to monetize some of its Shares since it would have to commence a new registration statement." Aside from this provision, it should be noted that the states of Washington and Alaska over very lengthy discussions were able to apportion the demands between the states within the RRA's general framework. These discussions, however, were premised on the assumption that separate divestiture schedules would be applied to each of the Foundations. If a combined schedule, however, were imposed on the Foundations, then the RRA would raise some very material concerns as currently structured. These concerns include the added pressure that each of the Foundations would have in selling their shares, and thus, the increased flexibility each would need to access the public market.

Additionally, section 14(b) of the RRA requires essentially that the Washington Foundation indemnify New PREMERA, any underwriter, and other related persons, for damages resulting from reliance upon information provided to New PREMERA by the Washington Foundation regarding any registration statement or prospectus. There are several reasons why this provision is unfair to the Washington Foundation. First, this provision was not included in the WellChoice Conversion. Second, the provision indemnifies New PREMERA for any liability arising out of its acts or omissions regarding such documents. It is not apparent as to why the Washington Foundation should indemnify New PREMERA for its violation of the law resulting from its own actions or inactions. Third, the Washington Foundation will most probably not provide to New PREMERA any information that the company would not already have in its possession. Fourth, even if this provision were to remain, it should be limited to information provided by the Washington Foundation that is in writing and not public. Presumably, New PREMERA will have access to public information and would, therefore, not rely on the Washington Foundation for such information in drafting a registration statement or prospectus. Although this provision is unfair to the Washington Foundation, by itself it may not rise to the level of compelling rejection of the transaction. The Commissioner may certainly take it into account along with the many other issues identified in this report in determining the aggregate effect of the proposed conversion.

7. Stock Restrictions Agreement/Transfer, Grant and Loan Agreement

Although PREMERA has eliminated the Stock Restrictions Agreement from the Amended Transaction, it has replaced that agreement with a similar agreement entitled the "Transfer, Grant and Loan Agreement" ("TGLA"). This agreement has been discussed previously *supra* at section

III.C.2.d because many of the provisions relate to the terms of the Washington Foundation's organizational documents.

8. Indemnification Agreement

PREMERA has eliminated the Indemnification Agreement from the Amended Transaction. Thus, the concerns raised in C&B's Final Report with respect to this agreement have been alleviated.

9. Stockholder Protection Rights Agreement

PREMERA has eliminated the Stockholder Protection Rights Agreement from the Amended Transaction. In order to prevent New PREMERA from instituting a Stockholder Protection Rights Agreement in the future, approval should be conditioned on PREMERA's assurance to that effect. To the extent that PREMERA provides such an assurance, the concerns raised in C&B's Final Report will be eliminated.

10. Excess Share Escrow Agent Agreement

The Excess Share Escrow Agreement is merely an agreement designed to ensure the performance of the Stock Governance Agreements, and has no significance as a stand-alone agreement. It is an important mechanism in the enforcement of the divestiture schedules and should be eliminated if the schedule is eliminated. Moreover, because it serves only PREMERA's purposes, any costs associated with the implementation of this instrument should be borne by PREMERA, not the Foundations (directly or by deduction from escrow assets). Additionally, it presents issues comparable to those of the Unallocated Shares Escrow Agreement with respect to voting and appointment of the escrow agent.

11. License Agreement

As part of the Form A filing, PREMERA has included a License Agreement under which the Foundations would be authorized to utilize the BCBSA Name and Mark, as well as PREMERA trademarks (collectively the "Trademarks"), in their philanthropic and charitable activities. It is not evident that there is a good reason for the Foundations to do so. Certainly, this agreement has not been included at the request of the Foundations (which do not yet exist) or the Regulators and their Consultants. Assuming that there is no conceptual objection to the possibility that the Foundations may want to use the Trademarks at some point in the future, the License Agreement merits some observations.

Under § 3, use of the New PREMERA trademark by the Foundations "shall inure solely to the benefit of New PREMERA." That being the case, it is even more difficult to ascertain the value of this agreement for the Foundations. But, beyond that, this obligation may serve to create an unintended liability for the Foundations. It may also undermine the basic purposes of the

Foundations, which are not to *inure solely to the benefit of New PREMERA*, as would be required by this provision.

Section 8 of the agreement obligates the Foundations to "assist New PREMERA in protecting and maintaining" its rights in the Trademarks worldwide. While PREMERA may not intend for this provision to be implemented as broadly as the terms permit, there is no obvious reason why the Foundations should be placed in this position. Moreover, were there ever to come a time at which Regulators commenced steps viewed by New PREMERA as threatening to the Trademarks, it would be awkward at best to have the Foundations be required to oppose such steps.

In short, there appears to be no compelling reason for the Foundations to use the Trademarks in their activities, and therefore no need for this License Agreement. But, even if it is viewed as desirable, its terms should be revised to eliminate unintended or undesirable liabilities and obligations.

V. CONCLUSIONS

In summary, the Amended Form A represents substantial progress towards alleviating some of the concerns identified with respect to the Original Transaction. Some issues have been resolved completely, while others have been mitigated to some degree. With respect to those mitigated issues, the Commissioner will have to determine whether the concerns identified by the Consultants have been sufficiently offset to permit approval without further action by PREMERA. However, there still remain many unresolved issues upon which the Commissioner would be justified in relying in support of a decision to disapprove the conversion. Many of these unresolved issues are a direct consequence of PREMERA's refusal to alter the structure of the Original Transaction until recently. These issues could possibly have been identified and resolved earlier. Nonetheless, the outstanding remaining issues have been narrowed sufficiently in order to permit the Commissioner to approve the Transaction subject to the satisfaction of certain conditions, if he so chooses. On the other hand, the Commissioner has ample reason to conclude that PREMERA will have to file a new Form A with changes that satisfy these concerns. What does not seem possible to C&B, is that the Amended Transaction can be approved unconditionally as currently constituted. In the end, none of what has transpired since discussions ensued with PREMERA should come as any surprise, because even the most cursory glance at C&B's Final Report foretold what would most likely occur as a result of postponing PREMERA's discussions with the Regulators and Consultants until the eleventh hour.

The following summarizes the conclusions with respect to C&B's Analysis of the following issues: (1) whether PREMERA has complied with the appropriate change of control filing requirements, (2) whether the Amended Transaction is economically viable, (3) whether PREMERA has complied with applicable law, including the Washington Insurance Code, applicable WASH. ADMIN. CODE provisions, the Washington Nonprofit Corporation Act, and certain provisions of federal law, (4) whether the Amended Transaction is fair to policyholders, health care providers, and the public, (5) the potential conversion-related self-dealing and conflicts of interest of PREMERA's officers and directors, (6) the independence of the Washington Foundation on the one hand, and

PREMERA on the other hand, and (7) the stock transfer documents, and the related transfer of PREMERA's fair market value.

1. **C&B does not have a significant concern regarding compliance with the change of control filing requirements.** Without opining on whether the Amended Form A is complete for purposes of the Holding Company Acts, and aside from those items deemed by Judge Finkle to be privileged, the Consultants appear to have received substantially all the information required to evaluate the Transaction. The items that were outstanding as of the issuance of C&B's Final Report, have since been received with sufficient time for review.

In determining the identity of the applicant, PREMERA suggests, inappropriately, that the Disclaimer of Control filing is the mechanism which eliminates control. However, for purposes of the public policies underlying the Holding Company Acts and other applicable law, New PREMERA should be treated as the acquiring person.

2. **The Amended Transaction may not be economically viable if concerns regarding the IPO Procedures Opinion and the Bring Down Opinions are not satisfied.** For purposes of C&B's Analysis, economic viability turns on whether the public's interest in PREMERA is safeguarded in the Amended Transaction. In effect, that requires a determination as to whether the fair market value of PREMERA will be conveyed to the Washington Foundation and thereafter inure exclusively to the public benefit. Initially, economic viability involves the extent to which PREMERA will be able to complete a successful IPO, which depends on several factors including whether the company follows proper procedures in the IPO. However, there are several potential negative factors that may affect the economic viability of the IPO, as reported by Blackstone. Moreover, even a successful IPO properly conducted would not guarantee that the Transaction will be economically viable in the sense described here. A variety of stock restrictions and other conditions proposed by PREMERA to be imposed on the Washington Foundation are likely to reduce materially the value of the consideration received by it for eventual distribution to charitable organizations. That reduction may result in the aggregate consideration falling so far short of the requisite share of PREMERA's fair market value that the applicable legal requirement will not have been met.

Some of these concerns are mitigated to some degree by the issuance of an IPO Procedures Opinion, which allows an investment bank, acting on the Commissioner's behalf, to be given access to the information and pricing of the Shares in the IPO, and eventually to issue an opinion encompassing, *inter alia*, the economic viability of the Transaction. There are two material problems, however, with PREMERA's proposal regarding the opinion. First, in order for the IPO Procedures Opinion to be reliable, Blackstone believes that at least four weeks prior to the start of the IPO "road show," PREMERA should make a preliminary proposal regarding the parameters of the contemplated IPO (size, split between primary and secondary shares, and pricing range) to the OIC and its advisors. PREMERA has not provided for such a presentation. Second, the Washington Foundation does not have the right to access, and rely, on the information on which the IPO Procedures Opinion will be based. The due diligence of the Washington Foundation in making a fully informed decision as to what portion of its Shares should be included in the IPO is materially affected. In making this determination, the Washington Foundation will be required to consider the potential dilution of the Shares and any potential IPO discount. If the Washington Foundation does not have the ability to access, and rely, on the information analyzed in the IPO Procedures Opinion, then, alternatively, the Washington Foundation must have the ability to appoint a joint book running manager in order to protect its interests.

Furthermore, it is necessary for the IPO to occur and the conversion to be completed within a reasonable time following the Commissioner's approval in order to avoid having that approval become a conversion "carte blanche" for PREMERA. If PREMERA did not intend section 4.3(b) of the Plan of Conversion to include the IPO, then the Transaction does not satisfy this concern. Recognizing that PREMERA will need some time after the Commissioner's approval to implement a successful IPO, and to satisfy all federal regulatory rules in conducting an IPO, the longer the lapse of time between the receipt of all regulatory approvals, and the IPO, the greater the likelihood of intervening material changes that make the approval inapplicable. PREMERA has provided a 12-month "window" after the receipt of all regulatory approvals and two three-month automatic extensions if there is pending litigation. These automatic extensions, however, infringe upon the Commissioner's authority to determine whether additional time is warranted for conducting the IPO. Lastly, the Initial Time Period does not begin until all regulatory approvals have been received, and until approval from the BCBSA is received with respect to the License Agreement. It is inappropriate to condition the Transaction on the BCBSA's approval because it is not a regulatory authority and not a party to this proceeding. Moreover, the Regulators and Consultants will have no role or influence on the substance and timing of the BCBSA approval process.

Additionally, the issue arises as to whether a material change has occurred during the Initial Time Period, which may affect whether the Commissioner would still approve the Transaction. The flexibility required for PREMERA to conduct a successful IPO, therefore, should be balanced against the possibility that material changes will occur affecting the Amended Form A during the Initial Time Period. The Bring Down Opinions will provide some safeguard against a material change, to the extent that the underlying information provided by PREMERA is adequate for the Consultants' review. These Reportable Changes, however, fail to provide sufficient information in several areas material to the Commissioner's review of the Transaction.

3. **PREMERA has not complied with applicable law.** Under the Washington Insurance Code, the Commissioner must find none of the Holding Company Acts' six adverse criteria, the first two of which are: (1) after the change of control, the domestic health carrier would not be able to satisfy a domestic health carrier's registration requirements, or (2) there is substantial evidence that the acquisition would substantially lessen competition or tend to create a monopoly in insurance in Washington.[175]

The first criterion for approval under the Holding Company Acts involves the licensing and registration requirements of PREMERA's health care service contractors and insurers without the

[175] The remaining four criteria for approval under the Holding Company Acts are discussed in the fourth conclusion.

need for the converted entities to file new licenses or registrations. The OIC has indicated that it will permit the licenses and registrations for the nonprofit companies to be transferred to the for-profit companies if the Transaction's other requirements are met, because there does not appear to be a material issue with respect to compliance with the underlying requirements.

The second criterion for approval involves the extent to which there is sufficient evidence that the acquisition would substantially lessen competition or tend to create a monopoly in insurance in Washington. Although PREMERA has market power in eastern Washington, there does not seem to be an antitrust violation as a result of the Transaction, because it does not appear that the Transaction will result in an immediate increase in market share. It is possible that access to additional capital will enable PREMERA to engage in anti-competitive behavior that would not have been possible without such capital. Nothing brought to C&B's attention indicates an intent by PREMERA to engage in such behavior. However, the need to satisfy investor expectations may induce PREMERA to increase premium rates or reduce provider compensation, either or both of which may have an adverse effect on the markets in which PREMERA operates.

Other applicable Washington Insurance Code provisions include the Form D requirements for certain material transactions in a holding company system between related entities, whether the insurance contracts of the current entities should be transferred to the converted entities, and whether solicitation permits have been provided. PREMERA's Form D appears to satisfy the applicable informational requirements. Moreover, PwC's analysis indicates that the Form D appears to satisfy the substantive requirements for the Cost Agreement and Management Agreement, because those agreements, as well as charges for services performed, do not appear to be unfair and unreasonable, and the expenses incurred and payments received apparently will be allocated according to customary statutory accounting practices consistently applied. The Tax Agreement, moreover, has been amended so that certain members are reimbursed for tax attributes generated on a separate return basis. The Guaranty Agreements, however, provide for different claims guarantee standards between the states, and thus, are unfair to the Washington public. The transfer of insurance contracts between PBC and New PBC, and LifeWise of Washington and New LifeWise of Washington, should not be approved as contemplated in the Amended Transaction in the absence of express adequate assurances that the transfer will not result in adverse changes in the terms or cost of coverage. The Amended Transaction documents contain an assurance with respect to the terms of coverage. With respect to the cost of coverage, PREMERA has provided some assurances pertaining to increases in premium rates, but those assurances are not for an adequate period of time. New PREMERA will be required to obtain solicitation permits for the IPO and subsequent financing which will have to be reviewed by the Commissioner to determine whether PREMERA has complied with applicable law. The proposed form for the application for these permits are not included as part of the Amended Transaction documents, and C&B, therefore, cannot ascertain whether they will comply with applicable law.

Moreover there are several concerns regarding the Washington Foundation's organizational documents and related agreements. The Attorney General and the Commissioner have the authority to determine whether PREMERA has satisfied its charitable obligation to the State of Washington. This analysis includes a determination of whether the purposes and corporate governance provisions of the Washington Foundation's organizational documents satisfy this obligation. First, an argument can be made that the Washington Foundation's Directors should not be compensated for that service. Second, the concerns regarding lobbying have been mitigated substantially because the Washington Foundation is independent from New PREMERA, and thus, concerns that the Washington Foundation will engage in activities which will benefit PREMERA are diminished. However, the Washington Foundation is prohibited from engaging in lobbying which would be materially adverse to health insurers. This provision restricts the ability of the Washington Foundation to determine the best method by which to promote its purposes. If PREMERA identifies specifically those issues on which the Washington Foundation may not lobby, then this concern may be mitigated to the extent that those issues do not raise similar concerns. Overall, PREMERA's willingness to make contributions to the Washington Foundation for lobbying purposes may not be inconsistent with the public interest to the extent that PREMERA does not influence the Washington Foundation's decisions regarding the issues on which to lobby with the use of those funds. Moreover, PREMERA has not indicated that it will fund future lobbying activities. If the IRS requests that the Articles of Incorporation be amended so as to prevent any restriction on lobbying, then it would not be contrary to the public interest to remove the lobbying restriction. These issues by themselves likely do not provide sufficient evidence to disapprove the Transaction, but may be factors for the Commissioner to consider. A related issue is whether PREMERA should prohibit the ability of the Washington Foundation to amend its Articles of Incorporation. Despite the fact that the Articles of Incorporation permit amendments, other agreements essentially restrict that right.

The exemption of the Washington Foundation's management from the codified "prudent person" rule standard for trusts investments in WASH. REV. CODE ANN. §§ 11.100.010–.140, "Investment of Trust Funds," is too broad. The only exemptions from WASH. REV. CODE ANN. Chapter 11.100 that may be appropriate are as follows: (1) the 10% limit of WASH. REV. CODE ANN. 11.100.023, (2) the duty to diversify investments under WASH. REV. CODE ANN. 11.100.047, (3) duties under WASH. REV. CODE ANN. 11.100.060, to the extent that PREMERA redrafts this provision to limit the exemption to any diversification requirement, and (4) the requirements of WASH. REV. CODE ANN. 11.100.140. The Articles of Incorporation and Bylaws provide protections which exceed those envisioned in the applicable statutory requirements for indemnifying directors and officers, however, the indemnification provisions are no longer of particular concern because the Washington Foundation's Board of Directors is independent from that of New PREMERA. Moreover, the Articles of Incorporation no longer conflict with the Bylaws with respect to the vote required to amend the organizational documents, although both agreements conflict with other documents. Lastly, the presumption of assent provision no longer conflicts with applicable law or with PREMERA's rationale for such a provision. Although the foregoing problems alone may not be sufficient to compel disapproval, they also are additional factors to consider.

The Washington Foundation's Articles of Incorporation and Bylaws prohibit amendments, generally, without a vote of three-fourths of the directors then in office and advance written approval of the Attorney General. The requirement that three-fourths vote is required for any amendment reduces the flexibility that the Board of Directors will have in modifying these agreements to meet certain needs of the Washington Foundation. While probably not an independent basis for disapproval, this point may be material to the Commissioner's evaluation of the Amended Transaction as a whole.

PREMERA has excluded from the Washington Foundation's Board of Directors those individuals who are members "of any hospital or hospital association or medical association in Washington." This a fundamental corporate governance question that will affect the decisions of both, the Attorney General and the Commissioner. Restricting the members that will serve on the Board of Directors will prevent the public from receiving the best representation available to protect its interest. While the Commissioner may find a need to reject the Amended Transaction on this basis alone, it is the type of concern that can be addressed effectively in a conditional order.

If the Attorney General finds qualified individuals to appoint to the Third Board prior to the IPO, then there is no reason to compel the Second Board to make fundamental decisions regarding the IPO. The Investment Committee is to be established upon PREMERA's appointment of the First Board. The First Board, however, is intended to perform ministerial functions only, and thus, there may be no need to establish the Investment Committee at that time. This provision also raises the issue of whether the Washington Foundation is independent from PREMERA. The second concern is that the level of experience required is much greater than the qualifications to be a member of the Board of Directors. The Attorney General may determine that there are individuals that have sufficient business experience to serve on the Investment Committee, but do not have experience with a public company as currently required. The third concern is that the Investment Committee has the power, without approval from the Board of Directors, to determine the control, and disposition, of the Shares. This is contrary to the Washington Foundation's core function, which is to balance the health care needs of the Washington public with the maximization of the proceeds to be received from the disposition of the Shares. Each of these issues, individually or as part of the evaluation in its entirety, support rejection of the Amended Transaction, or approval only subject to remedial conditions.

The proposed prohibition in the Washington Foundation's Restated Articles of Incorporation from amending, altering, or repealing its respective Articles of Incorporation or Bylaws may impede the Foundation's ability to make changes to its organizational documents in order to satisfy possible IRS concerns when trying to achieve § 501(c)(4) tax status. Typically when an organization seeks tax exemption from the IRS, that organization meets informally with the IRS in a pre-submission conference in order to determine what changes, if any, should be made to the organizational documents prior to the organization's formal application. If PREMERA requires that the Washington Foundation be responsible for any excise or other taxes associated with not achieving § 501(c)(4) status, then PREMERA must also give the Washington Foundation the flexibility to satisfy the requirements of the IRS. The Commissioner may have sufficient grounds to reject the Amended Transaction on this basis alone.

Although PREMERA has eliminated the Stock Restrictions Agreement from the Amended Transaction, PREMERA has replaced that agreement with a similar agreement entitled the TGLA. Generally, a significant portion of the agreement is either redundant, or inconsistent, with other agreements. Additionally, the TGLA inappropriately treats New PREMERA as a third-party beneficiary with the right to obtain injunctive relief. There is not a credible argument to support PREMERA's assertion that New PREMERA should be deemed a third-party beneficiary with respect to the funds expended by the Washington Foundation. Although the requirement that the Washington Foundation enter into a grant agreement in the first instance, or the specific provisions required to be included in the grant agreement, are unnecessary or inconsistent, there may not be sufficient evidence on the record to disapprove the Transaction on these bases alone. The TGLA, however, includes many of the same restrictions on lobbying and the use of proceeds that are included in the Plan of Distribution. The Commissioner may have sufficient basis on those grounds to disapprove the Transaction.

In PREMERA's Plan of Distribution, PREMERA has restricted the use of the assets to specific purposes, which are the same as those purposes enumerated in the Washington Foundation's Articles of Incorporation. Restricting the distribution of PREMERA's assets, specifically, to that enumeration is contrary to the public interest because the restriction prevents the Washington Foundation from having the flexibility to amend its purposes if deemed necessary such as when trying to achieve § 501(c)(4) status. Additionally, section 2(c)(iii) of the Plan of Distribution prevents PREMERA's assets from being used for "activities, programs or initiatives that likely would result in material adverse changes in the operations of entities engaged in the business of providing coverage of or the administration of health benefits, including, without limitation, any health insurer, health carrier, health maintenance organization or health plan in Washington or Alaska." This provision seems to be another inconsistency with the Washington Foundation's Articles of Incorporation because no such limitation exists in that document. And, even if there were such a restriction, it would not be in the public interest to handicap the Washington Foundation's decisions, which might ultimately be in the best interest of the public despite having an adverse effect potentially on health carriers. Furthermore, such provision is so broad that any activity conducted by the Washington Foundation may be considered adverse to health carriers. Accordingly, the Commissioner may have sufficient basis on these grounds to disapprove the Transaction.

The indemnification provisions for the indemnitees of the Washington Foundation are broader than the statutory requirements, but are not of material concern because of the independence of the Washington Foundation from New PREMERA. In other respects, C&B has concluded that the various transfer of asset agreements would comply with applicable law. The primary applicable non-tax federal laws are the Clayton Act and its amendment, the HSR. Although PREMERA will have to submit an HSR filing to the DOJ and the FTC, the Clayton Act's substantive federal antitrust requirements probably do not apply to the Amended Transaction, because PREMERA's market share immediately prior to, and after, the Transaction will be the same.

4. The Amended Transaction may not be fair to policyholders, health care providers, and the public. The last four criteria for approval under the Holding Company Acts require that the Commissioner not find that: (1) the acquiring party's financial condition is such as might jeopardize the health carrier's financial stability or prejudice its subscribers' interest, (2) the plans or proposals that the acquiring party has to liquidate the health carrier, sell its assets, consolidate or merge it with any person, or to make any other material change in its business or corporate structure or management are unfair and unreasonable to the health carrier's subscribers, and not in the public interest, (3) the competence, experience, and integrity of those persons who would control the health carrier's operations are such that it would not be in the interest of the health carrier's subscribers, and of the public, to permit the acquisition of control, or (4) the acquisition is likely to be hazardous or prejudicial to the insurance-buying public.

As a result of the Transaction, PREMERA may lose the benefits of the I.R.C. § 833(b) federal income tax deduction. Although PREMERA currently has certain tax credits to offset such a loss, projections indicate that those credits would be exhausted by 2007. Moreover, although PREMERA's cash flow may not be altered, the lower "book" net income may affect adversely investor perception as to PREMERA's profitability. PwC has determined that the risk of PREMERA experiencing a "material change in structure" and attendant loss of tax benefits, is significant, and even PREMERA conceded that it may not be able to provide a final "more likely than not" tax opinion. Thus, approving the Transaction may not be in the public interest due to the potential negative financial impact to the company, policyholders, and public. PREMERA will also face increased premium tax obligations in Alaska, although PREMERA has provided certain assurances that premium rates for Alaska subscribers will not rise as a result of this tax increase.

The fourth criteria for disapproval requires an analysis into whether the plans or proposals that the acquiring party has to liquidate the health carrier, sell its assets, consolidate or merge it with any person, or to make any other material change in its business or corporate structure or management are unfair and unreasonable to the health carrier's subscribers, and not in the public interest. As a starting point, the standard by which this determination is to be made should be considered. Additionally, this factor focuses heavily on the public interest. Therefore, as a further preliminary step, an analysis of the meaning of "public interest" is appropriate using various principles of statutory construction, such as the ordinary meaning of the term, policy considerations, and the doctrine of *in pari materia*. The ordinary meaning of the terms and policy considerations reflect a balancing of interests. Moreover, in reviewing the Washington Nonprofit Hospital Conversion statutes, the doctrine of *in pari materia* further supports the assertion that significant weight should be afforded to the impact of the Amended Transaction upon the health of the Washington public. As a practical matter, in making a determination as to whether the Transaction is unfair and unreasonable to subscribers or policyholders, and not in the public interest, the Commissioner may elect to balance the Transaction's anticipated adverse consequences to the subscribers, policyholders, and the public with the Transaction's potential benefits. In due course, this factor of the Holding Company Acts requires an analysis of the impact of the Amended Transaction on availability, accessibility, and affordability of health insurance, including potential negative financial impacts on subscribers, policyholders, and providers, and the consequences for uninsured and underinsured populations. This analysis also delves into management's due diligence obligations in greater detail.

Regarding the effect on the availability, accessibility, and affordability of health insurance, analysis is required as to whether PREMERA will be compelled to raise premiums or reduce provider costs. Premiums may rise as a result of shareholder pressure to improve profitability. On the other hand, provider compensation may be reduced to achieve the same result. PwC has analyzed the markets in which PREMERA operates and has determined that it has the market power to increase rates significantly in the individual and regulated small group markets. PwC's economic impact report shows that PREMERA has consistently fallen short of its target financial results. Shareholders may pressure management to improve profitability by increasing revenues or reducing costs. Premium rates could be a prime source for an increase in revenues, especially in areas where PREMERA has market power, and historically has not maximized the rates it could charge to subscribers while still remaining somewhat competitive. Moreover, the subscribers that would most be affected are individual and small group members, due to the greater ability to affect those markets. PREMERA, however, has provided certain assurances with respect to the manner in which rates are set. In PwC's view, these assurances lessen PREMERA's ability to increase premium rates for a period of two years after the Amended Transaction. PwC believes that these assurances should be provided for a term of not less than three years. Even with assurances for at least three years, PREMERA may be able to raise premium rates after that period. In sum, the Commissioner should consider whether PREMERA's assurances sufficiently offset the concerns raised by PwC to a degree which does not negatively affect policyholders or the public.

As demonstrated by PwC, PREMERA will have the ability to increase premiums to achieve internal target returns, but will still underperform as compared to publicly-traded comparable companies. Assuming that PREMERA does indeed raise premiums due to shareholder pressures, PwC's model also shows that certain members will most probably be compelled to drop coverage, or new enrollment may decline. These consequences of the Amended Transaction may cause an increase in the number of uninsureds, or reduce access to health insurance in the communities where PREMERA has market power. The Commissioner, therefore, should also consider whether PREMERA's assurances sufficiently offset this potential negative result of the Transaction. Additionally, in areas such as rural eastern Washington where PREMERA is functionally a single player, a particular concern is whether New PREMERA may leave the market if it cannot realize a sufficient return on investment.

In balancing the interests of the public, the Commissioner will be justified in giving little weight to PREMERA's implication that approving the Transaction will prevent premium increases, which otherwise might be necessary to raise capital, because such an implication does not have merit based on PREMERA's proposed uses of new capital. PREMERA's assertions that the Amended Transaction will somehow provide a substantial benefit to the company, due to an improved RBC ratio or enhanced ability to fund technological initiatives, are also not very persuasive given the lack of support for the necessity of these measures. However, assuming the Commissioner finds that the Transaction produces negative effects to subscribers, policyholders, providers, or the public, then the Transaction should be disapproved, unless PREMERA demonstrates other countervailing positive effects. PREMERA's suggestion that the Washington Foundation will provide benefits to offset the negative effects produced by the Transaction should be given little weight due to the lack of supporting evidence.

The Commissioner should also consider the weaknesses in PREMERA's due diligence identified in C&B's Final Report. By themselves, these weaknesses may not compel rejection of the Amended Transaction. However, they are an additional significant factor the Commissioner may consider in evaluating whether it is in the interest of policyholders and the public.

5. **The Amended Transaction presents potential conversion-related self-dealing and conflicts of interest of PREMERA's officers and trustees.** PREMERA's consideration of management retention in determining whether to convert, if there was no apparent need, could suggest a possible conflict of interest. If the Commissioner's factual inquiry produces a conclusion that there was not in fact a compelling meritorious motive for the Transaction, it will be important to ascertain whether benefits to management played a meaningful role. Furthermore, it will be necessary to determine whether anticipated management benefits present a conflict of interest of sufficient magnitude to make the Amended Transaction contrary to the public interest. PREMERA has included certain limitations and safeguards which mitigate to some degree the amount of additional compensation that management and directors stand to gain as a result of the Transaction. The Commissioner should factor these assurances into his consideration as to whether the Amended Transaction was motivated by some factor other than the best interest of the company. It should be noted, however, that there may not be sufficient evidence on the record to support the disapproval of the Transaction on this basis alone.

6. **The Washington Foundation would be sufficiently independent from PREMERA, although it may influence indirectly the Washington Foundation's lobbying activities.** PREMERA has structured the Amended Transaction in a manner which makes the Washington Foundation independent from New PREMERA. However, due to certain restrictions on the Washington Foundation's ability to lobby, and PREMERA's funding of these lobbying activities, it may be able to influence indirectly the decisions of the Washington Foundation. Moreover, the appointment of the Investment Committee at the time the First Board is installed may raise an additional independence issue. Although the Commissioner may not be able to justify disapproval of the Transaction on this basis alone, he may include this among the factors weighed in his deliberations.

7. **Elements of the stock transfer documents undermine the transfer of PREMERA's fair market value.** The Stock Governance Agreements prevent the transfer of fair market value to the Washington Foundation. These agreements are as follows: (a) the TGLA (b) the VTDA, (c) the RRA, (d) the Unallocated Shares Escrow Agreement, and (e) the Excess Share Escrow Agreement. As a general matter, there is no reason to treat the Foundations as a single shareholder when analyzing the foregoing documents. The VTDA is problematic because of provisions relating to the accelerated divestiture schedule, the number of shares held outside the voting trusts, voting of the Shares, the nomination, election, and term of the Designated Member, and the termination of the VTDA upon the termination of the License Agreement. The divestiture schedule purports to treat the two Foundations as a single shareholder by aggregating the shares that are required to be sold in order to satisfy each deadline. Each of the Foundations should have its own divestiture schedule and the right to hold 5% of shares outside of the voting trust without subjecting such provision to the BCBSA's approval. The VTDA should allow the Washington Foundation to vote on major corporate transactions which result in more than 20% of the outstanding shares being exchanged. The Washington Foundation should have the ability to vote on any new

SOP that is effective after the Stock Restrictions Period, but submitted to a shareholder vote during the first two and one-half years of the Stock Restrictions Period. Moreover, the Washington Foundation has a significant interest in ensuring that the Independent Directors do not have any direct or indirect material relationship with New PREMERA, because they will be controlling the voting of the Shares on many issues. Blackstone believes that the qualifications for Independent Directors are not stringent enough because a director could be considered independent even if another company that employs that director accounts for as much as $57 million in New PREMERA revenues. The Designated Member is to be appointed by the Foundations jointly. In order to safeguard its economic interest, the Washington Foundation, as a large majority shareholder, should have its own representation on the New PREMERA board. The term of the Designated Member should not be limited to five years, because the Washington Foundation could potentially still have a significant amount of New PREMERA stock at that time. PREMERA should not have a right to veto all of the Washington Foundation's three potential candidates on grounds other than that a candidate does not meet the qualifications as stated in New PREMERA's organizational document. There is no justification for preserving the VTDA if the License Agreement is terminated, or if the BCBSA eliminates some or all of the VTDA's restrictions as a condition for the use of the Name and Mark. PREMERA should memorialize the transfer of the Class B share from New PREMERA to the Washington Foundation.

The RRA is of concern because the underlying demand rights were apportioned between the states upon the assumption that each state would be subject to a separate divestiture schedule. Those allotments may be problematic to the extent that the Washington Foundation would now face added pressure to sell its Shares. Moreover, Blackstone believes that, if the Washington Foundation piggy-backs on New PREMERA's demand, then the Washington Foundation should have the right to continue the registration even if New PREMERA has terminated its participation. Additionally, the RRA's requirements regarding the indemnification of New PREMERA is unnecessary or far too broad.

The Unallocated Shares Escrow Agreement generally causes concern because if the uncertainty as to the proper allocation of the Shares among the states is of sufficient magnitude, placing the amount as to which there is uncertainty in the escrow might impair substantially the ability of the Foundations to make sufficiently informed decisions as to how to sell the stock allotted to them. Moreover, the agreement causes concern with respect to acceleration of the divestiture schedule, expenses, indemnification, selection of the escrow agent, and voting rights.

The License Agreement is unnecessary because there is no compelling reason for the Foundations to use the Trademarks. Regardless of the necessity, the agreement should be revised to eliminate unintended or undesirable liabilities and obligations.

VI. RECOMMENDATION

The proposed conversion is a complex transaction affecting many interests and constituencies. Companies contemplating such a transformation choose different paths on their way to completion. The model selected by PREMERA has been principally one of independent development, postponing a comprehensive dialogue with Regulators, their Consultants, and other interested parties until very late in the process. To be sure, there have been a large number of discussions among these parties since the application was first filed, but these have been principally in the nature of assisting the consultants to gather information for the analysis. At times there have even been a few substantive discussions about important elements of the conversion. What PREMERA has largely been unwilling to do, until relatively recently, is to discuss the Consultants' observations and to respond with proposed changes to the Transaction. In short, the company's position had been that it wanted one comprehensive set of observations in response to which it could make one set of changes. While there may be an appealing sense of efficiency in this approach, it tends to make much more difficult the process of developing a transaction that addresses effectively all of the areas of regulatory concern.

As originally filed, the Form A suffered from many infirmities, some potentially irremediable. The more serious of these were brought to PREMERA's attention approximately one year ago. However, PREMERA advised that it would not amend the application until the Consultants' reports were submitted, which eventually occurred ten months later. Following delivery of these reports in October 2003, there ensued a vigorous and accelerated dialogue designed to facilitate PREMERA's ability to submit an application more likely to receive approval. Not surprisingly, that dialogue served to uncover a number of fundamental flaws in the Amended Transaction, not all of which PREMERA was willing or able to resolve in a manner that the Consultants believed to be adequate. But, there were a number of significant problems that PREMERA was able to address satisfactorily.

Less than a month ago, PREMERA submitted its Amended Transaction, presumably representing its best effort. In many respects, it is a very significant improvement over the Original Transaction. For example, an indemnification agreement of great concern to the Consultants was eliminated. Similarly, the proposed Foundations have been made largely independent of PREMERA. And provision has been made for delivery of the Foundations' stock directly to each state's foundation. There have also been a number of other improvements, as described in this Supplemental Report. One issue that remains unresolved is the proper allocation of the Foundation stock as between Washington and Alaska. Admittedly, this issue presents a particular challenge for PREMERA. Given that its timetable does not permit it to put the conversion "on hold" while the issue is resolved by state officials, it has made an attempt to incorporate in the Amended Transaction provisions that will permit the conversion to proceed now. The Consultants have significant concerns about this proposal. But these concerns should not be interpreted as a criticism of PREMERA's attempt to cope with this challenge.

Unfortunately, the Amended Transaction still leaves unresolved certain issues of great concern. In a transaction of this complexity, it is very difficult to eliminate all issues of concern to regulators and other parties. Inevitably, the final terms incorporate numerous compromises on matters of less critical importance. It is not, however, issues in that category that lead C&B to conclude that the Amended Form A should not be approved unconditionally. Rather, the company has retained in the proposed conversion key elements that C&B believes are inconsistent with applicable legal requirements.

This Supplemental Report identifies many issues presented by the Amended Transaction. Unequivocally, not all, or even most, rise to the level of compelling disapproval. But there are a handful that present no other choice. PREMERA, on the strength of its BCBSA License Agreement, has chosen to treat the Washington Foundation and Alaska Foundation as if they were a single shareholder. There is simply no justification for this approach. Resort to the need to preserve the Name and Mark as a conclusive explanation belies PREMERA's disappointing failure to anticipate and address this issue with the BCBSA early in the process. The Consultants identified this problem no less than a year ago!

PREMERA proposes to impose upon the Foundations an array of voting and divestiture restrictions that are not clearly required by the BCBSA License Agreement. Giving PREMERA the benefit of the doubt, and assuming therefore that the BCBSA is imposing those requirements apart from those spelled out in the License Agreement, the result is the same. As is true of the treatment of the two Foundations as one, these requirements manifest a conscious decision by PREMERA to defer entirely to the BCBSA in these matters, probably in the mistaken belief that its conditions would be perceived by regulators and consultants as unavoidable facts of life. What this approach overlooks is any underlying obligation on PREMERA's part to get the best deal possible for the citizens of the states to which it owes its good fortune. Far from being an advocate for Washington and Alaska, it would appear that the company elected to play the role of a largely disinterested bystander insofar as the BCBSA's requirements are concerned.

In combination, these matters cast a long shadow on the ability of this conversion to deliver the requisite value to the Foundations. There are other important concerns as well. As a publicly traded company, PREMERA will simply have to be more profitable. The Consultants have worked vigorously to extract from management safeguards against immediate implementation of profit-enhancing measures deleterious to the interests of insureds, providers, and the public. The result, of course, has been a compromise. In the end, it remains a possibility that in two or three years the company can, and will feel compelled to, adopt market and other practices of the type about which most observers have expressed concern. Perhaps coincidentally, that will also be about the time that PREMERA has said it is simply no longer willing to accept restrictions on management rewards and incentives.

In the end, PREMERA overlooks one fundamental problem. It has not demonstrated a compelling need for change, let alone for this transaction. Having been unwilling to address adequately these most significant concerns (and many others of lesser importance), it can blame only itself if the Amended Transaction continues to fail the applicable legal standards. As it is currently constituted, C&B believes that the Amended Transaction is contrary to the interest of insureds and the public. Accordingly, C&B does not believe that the conversion can be approved in its current form under the applicable laws. It remains for the Commissioner to determine whether an order can be crafted that so conditions approval of the conversion as to overcome these problems without creating unacceptable new ones.

APPENDIX I: DOCUMENT PRODUCTION LOG

PREMERA DOCUMENT LOG

Beg Bates	End Bates	Document Date	Title
0038357	0038361	10/14/2003	Document Delivery Form providing response to request number E589 providing: for E587, how are BCBSA dues calculated
0038364	0038370	10/17/2003	Document Delivery Form providing response to request number E590A providing: response to the OIC's request on October 16, 2003 (Financial Information - Three Year Planning Tool)
0038371		10/20/2003	Document Delivery Form providing response to request number E591 providing: BCBSA National Campaign
0038361B	0038363	10/16/2003	Document Delivery Form providing response to request number E592 providing: Supplement executive compensation information as referenced in Exhibit B to Exhibit 4 of Premera's October 15, 2003 filing w/the OIC
0038372	0038445	10/20/2003	Document Delivery Form providing response to request number E593 providing: Premera's Stock Program
0038685	0038761	12/3/2003	Document Delivery Form providing response to request number WA28 providing: October 2003 Officer's and Director's Financial and Operational Review
0038446	0038468	12/1/2003	Document Delivery Form providing response to request number WA04c providing: Conversion Steering Committee Meeting Packet dated September 24,2003
0038469	0038540	12/1/2003	Document Delivery Form providing response to request number WA05c providing: Additional correspondence between Premera and Goldman Sachs
0038541	0038551	12/1/2003	Document Delivery Form providing response to request number WA18 providing: Additional information and analysis related to foundation shareholder
0038552	0038627	11/25/2003	Document Delivery Form providing response to request number WA28 providing: September 2003 Officers Financial and Operational Review
0038628	0038682	12/1/2003	Document Delivery Form providing response to request number WA129 providing: Additional public relations information
0038683	0038684	11/25/2003	Document Delivery Form providing response to request number E594 providing: Materials provided in response to PWC follow-up request related to officer turnover information.
0038762	0038763	12/18/2003	Document Delivery Form providing response to request number E596 providing: Updated RBC Projection~
0039097	0039100	12/23/2003	Document Delivery Form providing response to request number E595 providing: Crosswalk between Oct. 7, 2003 management projections and march 21, 2003 financial model.
0038764	0038957	12/22/2003	Document Delivery Form providing response to request number E601 providing: Investment manager reports for 9/30/03; MD&A 9/30/03; 9/30/03 Quarterly Reports
0038958	0038959	12/18/2003	Document Delivery Form providing response to request number E596 providing: Updated RBC projection
0038960		12/30/2003	Document Delivery Form providing response to request number E600 providing: no other presentations have been made to Premera by outside advisors/consultants which discuss the conversion or aspects related to the conversion.
0038961		12/30/2003	Document Delivery Form providing response to request number E599 providing: Premera's mktg. Research dept. has not produced any updated market share information since the information that was previously provided.
0038962	0038969	12/30/2003	Document Delivery Form providing response to request number E612 providing: Change in Accrured Benefit Cost, Projected Benefit Obligation and Assets; Watson Wyatt Letter-estimated 12/31/03 Financial Disclosures for PEP
0038970	0039096	12/30/2003	Document Delivery Form providing response to request number E610 providing: Executive Committee and Board Meeting minutes from BC of WA and AK; Articles of Amendment; Articles of Incorporation
0039177	0039178	1/10/2004	Document Delivery Form providing response to request number E613 providing: Groups moved from AK to WA estimated revenue, claims, commissions, premium tax, administrative costs for 2004 thru 2006
0039101	0039176	1/12/2004	Document Delivery Form providing response to request number WA28 providing: November 2003 Officer's and Director's Financial and Operational Review

PREMERA DOCUMENT LOG

BegBates	EndBates	DocumentDate	Title
0039179	0039181	1/29/2004	Document Delivery Form providing response to request number E614 providing: Pension, DBSRP and Postretirement December 31, 2003 actuarial reports from Watson Wyatt - outside pension actuary
0039182	0039184	2/9/2004	Document Delivery Form providing response to request number E615 providing:Taxes
0039185	0039186	2/9/2004	Document Delivery Form providing response to request number E616 providing: unrecorded asset or liability which exists
0039187	0039189	2/16/2004	Document Delivery Form providing response to request number E617 providing: RVCMOIC revised line of business report
0039190	0039212	2/17/2004	Document Delivery Form providing response to request number E621 providing: February 2004 Board presentation regarding year-end financial results and 2004 budget
0039222	0039266	2/17/2004	Document Delivery Form providing response to request number E618 providing: year end 2003 investment performance
0039220	0039221	2/17/2004	Document Delivery Form providing response to request number E619 providing: Investment watch list as of January 1, 2004
0039213	0039219	2/17/2004	Document Delivery Form providing response to request number E620 providing: 2004 budget presentation made to the Board on February 11 - in powerpoint
0039267	0039268	2/17/2004	Document Delivery Form providing response to request number E621 providing: most recent year-to-date financial results for each individual product line
0039269	0039344	2/17/2004	Document Delivery Form providing response to request number E622 providing: December 2003 beige book

APPENDIX II: BLUE CROSS BLUE SHIELD CONVERSION TRANSACTIONS

APPENDIX II

BLUE CROSS AND BLUE SHIELD CONVERSIONS

BLUE CROSS AND BLUE SHIELD CONVERSIONS

NAME	TYPE	DATES	COMMENTS
Blue Cross and Blue Shield of Kentucky	Merger/Acquisition	1993	Anthem acquired Blue Cross and Blue Shield of Kentucky in 1993.
Blue Cross of California	Conversion to for-profit	1993	Finalized. In 1996, WellPoint and Blue Cross of California merged into a single stockholder-owned company, WellPoint Health Networks Inc.
BlueCross and BlueShield of Missouri	Conversion	1994	Formation of RightChoice and the public offering of its stock.
Blue Cross and Blue Shield of Maryland	Proposed conversion from a nonprofit health services corporation to a for-profit stock insurance company	1994-1995	Proposed conversion was rejected by the Insurance Commissioner in January 1995.
Trigon Healthcare, Inc.	Demutualization and Initial Public Offering	1994-1997	Finalized. Anthem, Inc. and Trigon Healthcare, Inc. jointly announced that they have entered into a definitive merger agreement.

NAME	TYPE	DATES	COMMENTS
Community Mutual Insurance of Ohio	Merger	1995	Merged with Anthem Insurance Companies, Inc. in 1995.
Trigon Healthcare, Inc	Proposal to convert to a for-profit corporation and Initial Public Offering	1996	Completed 1996.
Blue Cross Blue Shield of Nevada	Merger	1996	Merger with Blue Cross Blue Shield of Colorado, purchased by Anthem in Colorado acquisition.
Blue Cross of Western Iowa	Merger	1996	Merged with South Dakota Blue Shield in 1996.
Blue Cross and Blue Shield of New Jersey	Proposed Merger	1996-1997	Proposed 1996 merger with Delaware BCBS put on hold because of undervaluation concerns. Deal called off in 1997 citing legal and regulatory hurdles in both states.

NAME	TYPE	DATES	COMMENTS
Blue Cross and Blue Shield of Texas	Merger with BCBSIL	1996-1998	Merger approved by Illinois and Texas Insurance Departments in late 1998. Challenged in court by Attorney General and approved on appeal July, 2003.
Blue Cross Blue Shield of Illinois	Merger with BCBSTX	1996-1998	Merger approved by Illinois and Texas Insurance Departments in late 1998. Challenged in court by Attorney General and approved on appeal July, 2003.
Blue Cross Blue Shield of Georgia	Conversion to for-profit company	1996-2001	Plan approved, class action lawsuits filed in 1997, settled July 1998. Acquisition by WellPoint Health Networks, Inc. in 2001.
Empire Health Choice (formerly known as Empire Blue Cross & Blue Shield)	Proposed conversion of Empire Blue Cross to for-profit, publicly traded company	1996-2002	Empire BCBS's conversion plan was approved in May 2000. In January of 2002, New York legislators and Governor Pataki approved a change in New York's insurance law allowing Empire BCBS to convert to for-profit status.

NAME	TYPE	DATES	COMMENTS
Blue Cross and Blue Shield of Colorado	Proposed Conversion and Acquisition by Anthem	1997-1998	Proposed conversion and sale to Anthem approved November 5, 1999, however two appeals resulting from that proceeding remain pending in the Colorado Supreme Court.
Blue Cross Blue Shield of Connecticut	Merger/Acquisition	1997-1999	Anthem Insurance Companies merger finalized in 1999.
Blue Cross Blue Shield of North Dakota	Conversion from a non-profit health services corporation to a non-profit mutual insurance company	1997-2000	Approved after a series of hearings in 1999 and 2000.
La Cruz Azul de Puerto Rico	Conversion from nonprofit to for-profit status	1998	Finalized.

NAME	TYPE	DATES	COMMENTS
Group Hospitalization and Medical Services, Inc. d/b/a BCBS of District of Columbia	Affiliated with Blue Cross Blue Shield of Maryland and Delaware	1998-2000	Merged with BCBS of Maryland in 1997. The combination of BCBSMD and GHMSI was completed in January 1998. CareFirst announced plans to affiliation with nonprofit BCBSD in December 1998. In January 1998 the combination BCBSD was required to maintain its nonprofit status for a period of two years, and that BCBSD agree to a "snapshot" valuation.
Blue Cross Blue Shield of New Hampshire	Acquisition	1999	Acquired by Anthem Inc., affiliated with CareFirst, the Maryland and D.C. BCBS plans in October 1999.
Blue Cross Blue Shield of Delaware	Conversion from a non-profit health services corporation to a for-profit domestic mutual insurance company	1999	BCBSD was required to maintain its nonprofit status for a period of two years, and that BCBSD agree to a "snapshot" valuation. The affiliation was approved in March 2000.

NAME	TYPE	DATES	COMMENTS
Associated Hospital Service of Maine (d/b/a Blue Cross and Blue Shield of Maine)	Conversion from a nonprofit hospital and medical service organization to a for-profit stock health insurer	1999-2000	Acquired by Anthem Insurance Companies, Inc. in May 2000.
Blue Cross and Blue Shield of Wisconsin	Proposed Conversion and Initial Public Offering	1999-2001	Conversion proposal approved in 2000, acquired by Cobalt Corp. in March 2001.
Blue Cross and Blue Shield of Kansas, Inc.	Conversion to for profit	1999-2000	Settled, August, 2000.
Blue Cross Blue Shield of New Mexico	Merger/Acquisition	2000-2001	Accepted an acquisition offer from Health Care Services Corporation (the owner of BCBSIL and BCBSTX.
Anthem Insurance Companies, Inc.	Conversion from a mutual insurance company to a stock company and Initial Public Offering	2001	Plan of Conversion approved by the Indiana Department of Insurance on October 25, 2001; Completion of its conversion from a mutual insurance company to a stock company, and became a wholly owned subsidiary of Anthem, Inc. October 30, 2001.

NAME	TYPE	DATES	COMMENTS
Blue Cross and Blue Shield of Kansas, Inc.	Sponsored demutualization and sale to Anthem	2001-2002	February 11, 2002, demutualization and application of Anthem formally rejected by the Insurance Commissioner. Rejection affirmed by the Supreme Court in 2003.
RightCHOICE Managed Care, Inc. d/b/a Blue Cross & Blue Shield of Missouri and Alliance Blue Cross and Blue Shield	Proposed Acquisition	2001-2003	Approved, August, 2003. Proposed acquisition of Healthy Alliance Life Insurance Company, HMO Missouri, Inc., HealthLink HMO, Inc., Wholly Owned Subsidiaries of RightCHOICE Managed Care, Inc. d/b/a Blue Cross & Blue Shield of Missouri and Alliance Blue Cross and Blue Shield by WellPoint Health Networks, Inc.
CareFirst, Inc., the Blue Cross and Blue Shield licensee in Maryland, Delaware, the District of Columbia and Northern Virginia	Conversion and acquisition by WellPoint Health Networks, Inc.	2001-2003	Rejected by the Maryland Insurance Commissioner.
Trigon Healthcare, Inc.	Proposed Acquisition	2002	Acquisition of Trigon Healthcare Inc. by Anthem, Inc. April, 2000.

NAME	TYPE	DATES	COMMENTS
Blue Cross Blue Shield of Vermont	Conversion	2002	Legislature refused to enact legislation.
Mountain State BlueCross BlueShield of West Virginia	Proposed Affiliation with Highmark, Inc.	2002	Pending.
Blue Cross Blue Shield of Delaware	Conversion and acquisition by WellPoint Health Networks, Inc.	2002	Rejected by the Maryland Insurance Commissioner.
Blue Cross Blue Shield of the District of Columbia	Conversion and acquisition by WellPoint Health Networks, Inc.	2002	Rejected by the Maryland Insurance Commissioner.
Blue Cross Blue Shield of North Carolina	Conversion from a nonprofit to a for-profit insurer	2002-2003	Initial Application filed January 2002, Second Amended and Restated Plan of Conversion dated September 30, 2002, withdrawn July 8, 2003. BCBSNC provided state regulators with revised conversion agreements that meet approval by the BCBSA September 16, 2003.

NAME	TYPE	DATES	COMMENTS
Premera Blue Cross and Blue Shield of Washington	Proposed Conversion and Initial Public Offering of Premera	2002 – Present	Pending.
Premera Blue Cross and Blue Shield of Alaska	Proposed Conversion and Initial Public Offering of Premera	2002 – Present	Pending.
Cobalt Corp., Wisconsin	Merger/Acquisition by WellPoint Health Networks Inc.	2003	Approval of proposed merger, September 19, 2003, by order of the Wisconsin OIC, and by the BCBSA (precondition of the merger by the OIC). Unites two Blue Cross/Blue Shield providers, adds almost 1M members to WellPoint in the Midwest. June 3, 2003, WellPoint and Cobalt announced that they signed a definitive agreement to merge. The transaction is structured as a merger of Cobalt with a wholly owned subsidiary of WellPoint.